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## **Breaking the paradigm : new approaches to pricing accounting services**

August J. Aquila

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# BREAKING THE PARADIGM

by  
**August J. Aquila,**  
Ph.D.

Issued by the  
**AICPA Management**  
of an Accounting  
Practice  
Committee

## NEW APPROACHES TO PRICING ACCOUNTING SERVICES

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American Institute of  
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## NEW APPROACHES TO PRICING ACCOUNTING SERVICES

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## DEDICATION

*This book is dedicated to both the accountants and the consultants to the accounting industry who have taught me so much over the last sixteen years.*

*To Ernie Wish, a true gentleman, accountant, and former managing partner of Coopers & Lybrand in Chicago, who brought me into the accounting profession and taught me so much.*

*To Irwin Friedman, managing partner of Friedman, Eisenstein, Raemer, & Schwartz, who constantly pushed me to achieve higher and higher goals.*

*Above all, I wish to dedicate this work to my daughter, Kate, a very special young woman who is on her way to achieving outstanding accomplishments.*



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## Preface

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When the AICPA Management of an Accounting Practice Committee asked me to author this work on pricing, I was quite honored. Being both a consultant to the profession and a professional services marketing educator has obviously influenced what I believe are the important points covered in this book. You will not find a “quick fix” to improve your profitability, nor will you find *the* way to obtain the highest fees for your services. Rather, I hope you find in this work some new ways of approaching an old problem — different strategies and new techniques that you can put into practice immediately.

The pricing of professional services is a complex and often difficult task. Accountants need to consider the demand in their particular market, what their competitors are doing, ethical restrictions, and the fact that accounting, tax, and consulting services are both intangible and perishable elements in developing their pricing goals and strategies.

Those of you who take this book seriously will find that it will have a tremendous impact on your practice and the types of services you will provide in the future. Your relationships with clients will improve, your cash flow will increase, and you will have more fun doing what you really enjoy — helping clients become more successful.

AUGUST J. AQUILA, PH.D., MBA  
Minneapolis, Minnesota

*January 1, 1995*





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# **Introduction**

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**T**he purpose of this book is to bring before the reader some new ideas and concepts about how to price the various services that accountants provide to their clients. There have not been many articles or books written about pricing methods for the accounting profession. Most of the literature relates to billing and collection.

This work is unique in the marketplace since its aim is to help the practitioner price his or her services. Even though your billing practices are diligently followed and your collections are under control, if you are not pricing your services properly, you are still leaving significant dollars on the table. This book will show you how you can price your services to receive the maximum fees possible.

Let's look at the following example. Your billing rate is \$125 per hour and you always try to achieve 100-percent realization. You provide a variety of services to your clients. These services range from simple compliance projects to more complex tax and business negotiations. Ask yourself the following questions: Are you doing justice to yourself and your client if you charge the client the same hourly billing rate to review his or her 1040 tax return as to assist the client in a complex merger and acquisition tax issue? Could you be overcharging in one instance and undercharging in the other? Could you be pricing your services at too low a rate? What if one service is worth \$100 per hour and the other \$175? Your average blended rate would be \$137.50, or 10 percent more than your current rate of \$125. Perhaps you are beginning to see the importance of determining a true value for your services. Making more money in the profession today does not require that you work more hours or work harder. It does require that you work smarter and learn how to price your services accordingly.

We as sellers have lost the art of pricing our services based on value. Instead, we have created an hourly billing method that is based on cost. The computed hourly rate

often bears little relationship to the client's perception of the value of the services rendered.

Take a minute to read the following quote from the *Management of an Accounting Practice Handbook*:

Time charges at standard rates should *only* [emphasis added] be the starting point for determining the amount to be billed. The real criterion is the value of the service to the clients. Too often, this is recognized only negatively by billing at less than standard rates. Actually, standard rates should not represent a maximum that can be billed for services; rather, they should represent a minimum.<sup>1</sup> [May 1993]

This book is as much about *value* as it is about pricing. Although accountants are providing an intangible service, it is a service that can have a great degree of value. And, that value is determined by the client, *not* by the provider of the service. The more we can identify and determine the value of our service to a client or a potential client, the more we will be able to use the concepts presented in this book. As you will see, pricing has to be a win-win situation or there will be no long-term relationship with the client.

I have tried to look at value and the ways that you can become more profitable by using the concepts and theories presented here in your day-to-day operations. A number of the examples presented in this book come from practitioners throughout the country. Many are ideas that I have suggested to firms during my years of consulting. It is important to remember that the ideas presented here are meant for use by all accountants, from the sole practitioner to the Big Six accounting firms.

This book contains six chapters. Chapter 1, "Traditional Pricing Methods and Marketplace Orientation," explains the traditional methods of pricing and provides insights into why they are outdated and need to be challenged. Chapter 2, "Marketing and Pricing," discusses the concepts of marketing and pricing, the product life cycle, demand, different competitive environments, and explains how pricing is actually a marketing activity. Chapter 3, "Utility and Value and How They Affect Pricing," explores the ways you

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<sup>1</sup> *Management of an Accounting Practice Handbook*. New York: American Institute of Certified Public Accountants, 1993, chapter 203, pages 3 and 4.

can add value to your services. Chapter 4, “Alternative Pricing Methods,” looks at a variety of alternative pricing methods and how they should be used. Chapter 5, “How to Implement a Change in Pricing Philosophy,” discusses ways to implement a change in your firm’s pricing philosophy. Chapter 6, “How to Bill and Collect Effectively,” discusses the key elements for an effective billing philosophy.



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**Chapter 1**

**Traditional Pricing  
Methods and  
Marketplace Orientation**

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**T**he time has come for the accounting professional to rethink the paradigm on which pricing has been based. This chapter will discuss the traditional methods of price setting and how they can have a negative impact on a firm.

Somewhere along the line, accountants began to believe that an hour of their work had a set value to their clients. As we shall see, this false assumption has caused accountants to —

- Produce more chargeable hours by constantly reinventing the wheel.
- Hoard work and, consequently, do a poor job of delegating.
- Inhibit the creation of more efficient ways of producing accounting services.
- Inhibit the development of more efficient project management.

In short, the hourly billing system under which we now work rewards inefficiency and penalizes productivity. Let's take a look at the two traditional systems of setting hourly fees, the Rule-of-Three and the cost-plus methods.

## **THE TWO TRADITIONAL METHODS**

### **The Rule of Three Method**

In the accounting profession, we have all heard of the Rule of Three. The Rule of Three mainly applies to leveraged practices, in which the practitioner employs professional staff and administrative personnel. This rule states that one-third of the fee covers overhead, one-third covers compensation, and the last third goes to pay the partners or owners. A number of medium-sized firms would be happy to have a 33-percent profit margin for distribution to the partners or shareholders. Most sole practitioners laugh at



the Rule of Three and instead follow the rule of two — that is, they generally net 50 percent on fees.

Here is a quick and simple way to figure what your billing rate should be based on the Rule of Three. If you want to figure your billing rate (that is, the price you are going to charge for your time), take the salary you want to make, multiply it by three, and then divide the total by the number of billable hours you think you are going to work.

The following example demonstrates how a leveraged practice would determine a practitioner's billing rate based on the Rule of Three. Assume you are a practitioner and want to make \$60,000 a year. The equation you would use to compute this following the Rule of Three is as follows:

$$\begin{aligned} & \$60,000 \text{ (desire annual salary)} \times 3 = \$180,000 \\ & \frac{\$180,000}{1,200 \text{ hours (projected billable hours)}} = \$150 \text{ (average} \\ & \hspace{15em} \text{hourly billing rate)} \end{aligned}$$

The preceding example shows that when using the Rule of Three, billing rates are determined solely by the number of billable hours, without any consideration to any other market factors (for example, competition, demand, or services offered). The bottom line is volume, that is, production. The emphasis is on how many billable hours each and every professional can accumulate. Added to that, of course, is the emphasis on the billable rate and the realization of those billable hours. Some firms even kid themselves into thinking that production is the be-all and end-all. They do not realize that production in and of itself means nothing if the fees billed are not collected. The most profitable firms place just as much emphasis on fees collected and compensate partners accordingly. Another common oversight made by firms that focus on production and the firm's need to meet billable hour goals is the lack of emphasis on the client's needs and providing the services that clients require and want. Firms that do their homework and change their pricing strategies have discovered that the Rule of Three has become obsolete.

## The Cost-Plus Method

Since the traditional accountant's paradigm is that we sell time, the most popular method of setting fees in the accounting profession has been and continues to be the cost-plus or hourly pricing method. The real key to the cost-plus method is gaining a *complete* understanding of the cost of running your practice. The following exercise will help you determine the true cost of providing your services. First, you will write down the figure you think is the cost of running your accounting practice. Next, take a few minutes and calculate the real cost of running your firm. Every firm, whether a multioffice or sole practitioner, needs to know what this number is. Let's see how close your estimate comes to the actual cost.

1. Annual cost of running your practice      \$\_\_\_\_\_
2. Number of billed hours (net hours  
after write-offs)      \_\_\_\_\_
3. Additional hours written off because  
of bad debt      \_\_\_\_\_
4. Total number of net billable hours      \_\_\_\_\_
5. Divide the annual cost of running your  
practice (item 1 above) by the number  
of net billable hours (item 4 above)      \_\_\_\_\_

Let us go through an example: You are a sole practitioner and the annual cost of running your practice is \$85,000. If you bill 1,400 hours net, then the cost of overhead per hour is \$60.71 (\$85,000 divided by 1,400 hours). This figure, of course, will vary from year to year, but the variance will not be significant, even if the firm has dramatic growth. Knowing the cost of overhead per hour now permits you to add a profit amount. This is the *plus* part of the equation.

If our sole practitioner wants to have an income of \$75,000, then he or she must add an additional \$53.57 per hour (1,400 hours  $\times$  \$53.57). The cost-plus billing rate for this practitioner would then be set at \$114.28.

Of course, I would hope that most accountants would compare this rate with what the competition is doing. If the rate is much higher than the going market rate, then our sole practitioner might lower his or her rate, or decide to perform a specialized service with a higher value for the client. If the rate is below the going rate, then our sole practitioner will raise his or her rate. In one case, a practitioner doubled his rate but lost only \$5,000 in clients and increased his net revenue significantly.

As long as you know the true cost per hour, you will never unknowingly quote an hourly fee below your cost for an engagement. There is a story in the retail industry that goes like this: "Well, we may be losing a little on each shirt that we sell, but we'll make it up in volume." That would be like an accountant saying, "Well, we may be losing a little on each hour of work that we do, but don't worry about it, we will make it up on volume." If you know the true cost of doing business, you will never have to say this.

The preceding example shows that in using the cost-plus method, the focus is once again on billable hours even though it is based on cost estimates. Furthermore, when using the cost-plus method, you are also focusing on cost. Think for a moment about what this implies. If you determine your fees based on cost and billable hours, you are looking *inward*. It is as if you are working in a vacuum. Unfortunately, too many accountants actually function this way. If, on the other hand, you are truly client-centered, you know that the client is at the center of your thought process and that everything you do is to better service the client. It is the client who ultimately determines the value of your service.

## MARKETPLACE ORIENTATION

Let's look at the different focuses or orientations that firms can take toward managing and running their practices and see which the traditional pricing methods encourage. Any organization, whether an accounting firm or not, usually tends to have one of four focuses. They are either selling-oriented, product-oriented, production-oriented, or marketing-oriented. Each focus will have a direct impact

on how a firm looks at servicing its clients and pricing its services. The predominate focus is often dictated by the value system of the founders of the organization. Perhaps when the firm was first started, the predominate focus was appropriate. However, a danger develops if the external environment changes and the internal environment of the firm stays the same.

## **Selling Orientation**

The selling orientation basically assumes that clients will not buy the product or service unless the organization makes a substantial effort to stimulate their interest in its products.<sup>1</sup> Currently, there are only a handful of accounting firms in the country that have really embraced this orientation. There is a movement, however, among accounting firms to hire part- and full-time sales professionals to develop leads for the firms. In reality, these firms are trying to increase their market share merely by increasing their selling power. It may not make any difference that their services and products are outdated, or that their service quality is considered unsatisfactory by the market. Firms that embrace the selling concept will start spending more on advertising, public relations, direct mail, and other kinds of activities that should increase demand for their services. It seems that it is too early to tell if this focus can be successful in the long run. Traditionally, organizations that really believe in this orientation have a very strong sales force. Also, when there is a surplus either of the service or a good, firms will begin to take a stronger look at hard selling. There is no doubt that in the accounting profession today, there is a surplus of providers. Even if outside salespeople are not used, there will be more pressure on partners to “sell” more as long as the external environment continues its current course.

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<sup>1</sup> Philip Kotler, *Principles of Marketing*. Englewood Cliffs, NJ: Prentice-Hall, 1980, page 21.

## **Product Orientation**

Those firms that follow a product orientation believe that clients will purchase the service or product that is the best in the market. The organization's primary task is to constantly improve the quality of their products. It is through product quality that these firms believe they will keep and obtain new clients. Product quality in the accounting profession is very difficult to distinguish from one firm to another. It is virtually impossible for the client to determine who has the best quality. Most clients cannot judge the quality of your audit work, the quality of your tax research, or the quality of your systems consulting expertise. For professional and intangible services, trying to differentiate your service based on a quality product or product enhancement will be extremely difficult. The major problem with this orientation is that a firm can believe that it knows what its clients really want. Product-oriented firms seldom speak with or listen to their clients.

## **Production Orientation**

In a nonaccounting environment, the production focus is often appropriate if the demand for the product or service exceeds supply. In today's marketplace, there are very few areas in the country where demand for accounting and tax services exceeds supply. There is, however, another situation where this concept makes sense. If the product's cost can be reduced through production efficiencies, then it may make sense to follow this concept. However you look at it, the production focus means that the organization places most of its emphasis on making and distributing the product or service. Philosophically, this means that the organization believes that its customers are there to buy whatever the firm produces, rather than the firm trying to determine the needs of its clients and then developing services or products that could best meet those needs.

Most accounting firms, whether they realize it or not, go into production orientation during tax season. I can think of many accountants who know exactly how many tax returns they were able to complete during tax season, and

the higher the number, the prouder they are. No doubt these individuals had achieved a high degree of efficiencies in producing and distributing tax returns. But what about the clients? Was sufficient time spent with the clients?

As demonstrated earlier in this chapter, neither the Rule-of-Three method nor the cost-plus method of determining billing rates takes into consideration an effective way to measure the value of the service to the client. By focusing on volume and cost, both the Rule-of-Three and the cost-plus methods foster a production orientation in firms. Firms that use these traditional methods sell hours, forgetting that it is the benefit or *value* of the service that is most important to their clients or prospective clients. The result is a production orientation in firms.

## Marketing Orientation

Focus is what sets the marketing orientation apart from the others that we have just discussed. Those firms that embrace the marketing orientation seek to understand the needs of their target markets and then offer them the services and products that meet those needs better than any of their competitors. If we apply some of these ideas to an accounting firm, the first thing that comes to mind is to ask ourselves, "What knowledge do we have of our prospective clients' and our current clients' needs and wants?" Many accountants say that they know what their clients want. When asked how they know this, they just answer, "I know." They have never taken the time to survey their clients. Marketing is discussed but not truly practiced in these firms. Or they confuse the marketing concept with selling their existing services to clients who may or may not want or need those services. If the emphasis is mainly on selling, or moving the services through the firm more efficiently, where does the client fit in?

How many firms actually organize their firms to satisfy the needs of their clients? Firms that embrace the marketing orientation follow these three basic principles:

1. Through surveys and other means of communication, they find out what their clients *really* need and want.

2. They provide the necessary services that will satisfy these needs and wants, whether they have the in-house capabilities or refer the service through some sort of strategic alliance with other consultants.
3. They develop methods of delivering their services more effectively and efficiently than their competitors.

## HOW A PRODUCTION ORIENTATION CAN BE HARMFUL TO A FIRM

A pure production orientation can have negative consequences for an accounting firm. These consequences include a focus on internal measures, billable hours, and technical aspect of tasks, and inhibit the development of a marketing orientation. A discussion of these four consequences follows.

1. *A production orientation gives the firm an internal rather than an external focus.* By emphasizing volume, accounting firms are using internal measures to price and evaluate their services and the contributions of their staff rather than letting the market determine the true value of the services they are offering. I would like to suggest that firms need to change their focus from emphasizing volume to emphasizing profitability. To do this, firms will need to take more of a value-based approach to their services. We will explore this concept in more detail in chapter 3, “Utility and Value and How They Affect Pricing.”
2. *A production orientation causes the firm to focus on billable hours.* The use of billable hours to price services and to evaluate performance creates at least three marketing-related problems in most firms.

Billable hours are truly the antithesis of client service. The natural incentive is to bill more hours, which results in higher fees, rather than to perform the service in the most economical fashion. The accountant may not even be aware that he or she is giving a silent — or not so silent — message to the client that the time spent is more important than the value provided. Since the focus is on time, we may not even think about the client as

much as we should. For example, it is not uncommon in many firms to have several professionals spend time in the preparation and review of a tax return. Does each person really add value to the process? In most cases, the answer is no. In short, there are often too many accountants assigned to an engagement.

Billable hours focus on individual performance. Now, there is nothing wrong with individual performance. We all need to keep score and know where we stand throughout the year. But, as any sports team knows, teamwork and cooperation are just as important as an individual's score if the team wants to win the championship. For an accounting firm to win the championship, that is, to have a very successful year, both teamwork and cooperation are crucial. In addition, they are also needed for a successful accounting firm marketing program. Lack of teamwork and cooperation may also inhibit cross-selling. Even worse, it may push someone who is not the best qualified in the firm to perform a service for a client. The results of such a scenario include a dissatisfied client, a potential write-off, and the possibility of a lost client or a lawsuit.

Emphasis on billable hours also encourages accountants to drift into services where they can bill more time. These services may not fit the strategic direction of the firm and they may not be consistent with the growth or profitability goals of the firm. For example, Joe has a certain interest and skill in nonprofit accounting. The firm has decided that it does not want to take any engagements unless the realization is at least 80 percent. But since there is so much emphasis on billable production, Joe continues to go after work in this area. He does reach his billable hour goal, but the overall realization is less than 60 percent. The firm believes he has wasted his time and ultimately reduces his draw. Thus, he becomes further discouraged and the firm's profitability suffers. Both Joe and the firm lose in this situation.

3. *A production orientation emphasizes the technical aspect of tasks, thus likely producing technicians instead of client service professionals.* Production-oriented firms create and encourage technicians, that is, accountants who



have excellent technical abilities, but lack skills in building client relationships, business development, and communication. These accountants often develop an employee mentality rather than an entrepreneurial spirit. They soon become more comfortable working for other accountants' clients rather than going out and getting clients of their own. If this is happening in your firm, you might want to see where you are placing your emphasis.

4. *A production orientation keeps a firm from developing a true marketing orientation.* This is perhaps the most significant and most harmful consequence of using billable production to determine compensation. Emphasis on production has resulted in professionals who do not understand marketing or its importance to the firm. Such professionals often equate marketing with marketing tools, such as newsletters, public relations, advertising, seminars, and brochures, while failing to acknowledge the strategic value of decisions on pricing, service and product, and delivery.

The following example is a clarification. We have two partners in two firms, A and B. Both partners have the same talents and skills. Firm A is a production-oriented firm and firm B places equal importance on marketing and production. In firm A, the partner's compensation is based on billable hours. What do you think this partner will do, and where do you think he or she will spend his or her time? In firm B, both marketing and production factor into the compensation formula. At the end of the year, each partner reports on his or her results. This is how they may look:

<i>Firm A</i>	<i>Firm B</i>
1500 Hours at \$100 per Hour	1300 Hours at \$100 per Hour
Marketing Hours— Zero	New Business— \$45,000
Management Hours— Zero	Management Hours—
Total Value to the Firm—	100 Hours— \$10,000
\$150,000	Total Value to the Firm—
	\$185,000

In this simplified example, it is quite easy to determine which partner's activities are worth more.

## CHANGING FROM A PRODUCTION ORIENTATION TO A MARKETING ORIENTATION

There is no quick way to change from a production orientation to a marketing orientation. To help you evaluate your firm, see table 1.1.

**Table 1.1**

<i>Function</i>	<i>Marketing Orientation</i>	<i>Production Orientation</i>
Attitude Toward Clients	Clients' needs are pivotal in determining firm's policies.	Clients should be glad we exist because of our high-quality service and cost consciousness. Firm sells what it can produce.
Service Development	Firm produces what clients need and will purchase.	Firm sells what it can produce.
Profit Orientation	Profit potential is a key consideration when developing services designed to satisfy clients' needs.	The residual that remains after costs have been covered.
Marketing Research	Designed to assess client's needs and determine how well the firm is meeting these needs.	Designed to determine clients' reaction, if used at all.
Role of Advertising	Acquaints prospective clients with the benefits of a service or benefits of employing the firm.	If used at all, lists staid service features, office hours and locations, and other production-based information.

(continued on next page)

**Table 1.1 (continued)**

<i>Function</i>	<i>Marketing Orientation</i>	<i>Production Orientation</i>
Service Innovation	Focus is on marketplace and determining new growth opportunities consistent with the resources of firm.	Focus is upon technological developments.
Focus of Top Management	Assess needs of clients, determine growth areas, monitor client satisfaction, and provide marketing leadership.	Determine ways of selling what the firm wishes to produce. Assess service quality only from an internal review perspective.
Fee Development	Determine the elasticity of demand for various services. Consider the value of service to clients and assess competitive fees.	Approaches fee development from a cost-plus perspective.
Practice Development Program	Based on a strategic analysis of both needs of the firm and diverse needs of targeted client segments.	Based on traditional practice development lore and personal preferences.
Use of Personal Selling	Delivery staff regularly assesses clients' needs. Promotes to new clients and prospects service offerings of direct benefit to them.	Reluctance among staff to actively sell services.

This table is important because too many firms think that they are marketing oriented when in reality they are production oriented. You should look at each of the preceding functions and determine how you *really* feel about them and execute them in your daily business life.

It will be a slow process because you are really changing the culture and individual attitudes in the firm. The following is a tested way that will help you make the change in your firm: The most logical and important way to reduce a firm's dependence on billable hours is to change the way fees are determined and partners are compensated. Chapter 4, "Alternative Pricing Methods," presents several alternative billing methods for you to consider. It is important to remember that when you calculate fees on the basis of how many hours go into a particular engagement, you are ignoring all external influences on the pricing equation. And, unless you change the way that you are going to compensate your partners and staff, not much will really change. Chapter 5, "How to Implement a Change in Pricing Philosophy," presents a truly performance-based kind of compensation arrangement that encourages a marketing orientation. Firms that are moving in this direction do it slowly. They may experiment with one arrangement and involve only a few professionals to gain a better understanding of the process and the pitfalls.

To find out how marketing-oriented your firm and its pricing strategies really are, complete the questionnaire in exhibit 1.1 on page 22. Similar to a balance sheet, your answers will give you a snapshot of where you are today. Your goal is to lay out a plan to get you where you want to be tomorrow.

***Exhibit 1.1 Your Firm, A Self-Analysis Exercise***

1. Describe your firm's image from your point of view.

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2. How would individuals outside of the firm, such as your clients and referral sources, describe your firm?

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3. Describe the unique characteristics of your firm.

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4. Describe the promotional activities of your firm that acquaint the clients and prospective clients with the benefits of a service or the benefits of employing the firm.

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5. How much time do you spend assessing the needs of clients, determining growth areas, monitoring client satisfaction, and providing leadership to your staff and fellow partners?

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6. List those services that you believe merit a premium billing.

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7. What percentage of your firm's business falls under the services listed in question 6 above?

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8. What has been the demand for your other services?

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# **Chapter 2**

## **Marketing and Pricing**

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**I**n 1977, the landmark United States Supreme Court decision in *Bates & O'Steen v. State Bar of Arizona*, 433 U.S. 350 (1977), changed the accounting profession forever. That landmark decision enabled accountants to pursue a wide range of marketing activities. Ever since, accountants have been struggling with the meaning of marketing and with the impact of marketing on their practice. Some would say that it has been the best thing that ever happened to the profession and others, of course, would voice just the opposite opinion. Whichever side of the debate you are on, there is one certainty: Marketing is here to stay.

This chapter will introduce you to several marketing concepts that businesses consider when pricing their product. We will discuss the following:

1. The marketing mix and its relationship to pricing
2. The product life cycle and the impact on the accounting profession of its place in a mature market
3. Demand
4. The various competitive environments in which firms can find themselves

Firms working to develop and maintain a marketing orientation will find these concepts helpful in changing their pricing paradigm.

## **THE MARKETING MIX**

Any introductory marketing textbook will tell you that in order to effectively market your product or service you need to first identify your target market. A target market is the people that you believe are most likely to purchase your product or services. Once you do that, you then need to develop a marketing mix to present your service or product to the target market. The marketing mix is often referred to



as the *Four Ps*: product (service), promotion, place (distribution), and price. These are variables that can be not only controlled by an accounting firm, but also changed or modified to meet the needs of the target client. The role of marketing is to take these variables and put them together in an integrated marketing program that is designed to meet the needs of the target market and, at the same time, take into consideration the resources and constraints of the firm.

My experience in working with hundreds of accounting firms is that they fail to take into account the enormous potential to fully develop all the elements of the marketing mix, especially the elements of place and price. Many firms think that they are developing an effective marketing mix by offering seminars, sending out newsletters, and writing articles. They fail to review, analyze, and balance all elements of the marketing mix. Each element is discussed below.

## **The Product or Service**

This element is what you are offering to the target market. You must determine, for example, if you will offer your target market only compliance services or if you will expand your firm's scope to include various kinds of consulting and value-added services.

Many firms today are good at developing services for various target markets or niches that they have identified. For example, the services a firm offers to closely-held and family-held businesses would include succession planning, compensation issues for family members, resolution of family conflict issues. The services a firm offers to nonprofit clients include member services, unrelated business tax issues, and financial reporting as required by the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards Nos. 116, *Prior Period Adjustments*, and 117, *Accounting for Leases—Initial Indirect Costs*. The services that firms might offer to construction clients would be quite different from the ones just mentioned. Service decisions do not appear to be a critical issue for most firms today.

## Promotion

This element is how you communicate your message — the benefits of your product or service — to your target market. Will it be by direct mail or by advertising in print, radio, cable television, or on billboards?

Promotional programs have probably been on center stage over the last several years when it comes to marketing. Actually, there has been a great deal of confusion that marketing consists of only promotion and its components, such as public relations and advertising. It was quite easy to develop this particular segment of the marketing mix, especially since so many of the early marketing directors came from a public relations or communications background. Promotional programs were also seen as a quick way to attract new clients. Once the basic needs and characteristics of specific market niches were identified, a promotional program could soon be developed. For example, promotion to the nonprofit market might include the use of bimonthly marketing roundtables, niche newsletters to the nonprofit organizations and seminars on membership services and on the unrelated business income tax (UBIT). Promotion for the construction industry might include participation at industry conferences, niche newsletters, advertising, and direct mail.

## Place

This element is how you will distribute your product or service to the market. For an accounting firm, this usually means determining whether you will have more than one office and where each office will be located. It could also include how you deliver your final product to the client; for example, electronic filing, electronic-mail (E-mail), or the use of LotusNotes<sup>®</sup>, or another kind of groupware.

In the past, very little attention was given to location and distribution decisions. Depending on the kind of professional service being offered, location and distribution vary in importance. For example, the physical location of a physician's office is a crucial element in the success of the practice. The location would be more important for a tax-

oriented accounting practice than it would be for a full-service accounting practice because, typically, more clients would be coming to the office in the first practice. Some law firms specializing in insurance defense are finding that the distribution of their service is becoming a critical element in their ability to serve their clients. Major corporations are requiring that their outside legal counsel be connected to them by a computer network. If a law firm does not have the technological capability, the insurance firms will not work with that particular firm. So far, the accounting profession has not experienced the impact of distribution requirements from its clients. However, the entire issue of electronic processing is an indication of what we can expect and it is becoming more common today for the client and the accountant to deliver and interface via some form of electronic media.

## Price

This element is how much you charge for your product or service. It can take many different forms, such as salary, rent, or fee. Price has a major impact on the other three components of the marketing mix. But, unfortunately, in most accounting firms less time is given to developing innovative pricing strategies than to any of the Four Ps. It is possible that determining the price for his or her service is the most difficult task facing every accountant. New accountants and experienced accountants alike all struggle with the issue of pricing.

Pricing in the real world is much different than in the accounting profession. Usually, wholesalers and retailers set their prices by using markups as the product moves through a distribution channel. Producers or manufacturers usually set the list price. Various methods or strategies are used by producers to determine their prices.

**Average Cost Strategy.** Average-cost pricing consists of adding a reasonable markup to the average cost of a product. Target-return pricing adds a targeted return to the cost of the product.

**Price Leaders.** There are price leaders in any market. They determine the going price for the product or service and all other competitors follow suit. The firms that are price leaders normally have an excellent understanding of their costs and the demand for their products or services.

**Prestige Strategy.** Other companies develop a prestige pricing strategy. They set their prices high to suggest the high quality or the high status of their products. Blue-chip consulting firms often follow a prestige pricing strategy.

**Bait and Switch.** This strategy is definitely not recommended for any firm. It is included because it is commonly used by retailers in developing their pricing strategies. This pricing strategy falls at the other end of the spectrum. Firms that employ this kind of pricing strategy announce a very low price with the purpose of attracting customers. As the name implies, the firm does not intend to sell the product or service at these artificially low prices, but rather to get the customer to purchase a higher priced item or service. All you need to do is to check the local paper for audio and stereo equipment to get an idea of this kind of pricing strategy.

**Market Penetration Strategy.** This pricing strategy is normally used when a service provider or manufacturer wants to buy market share. To achieve a significant share of the market, the firm would price its services or goods at a very attractive price. Some firms set their fees based on their marketing strategies. If, for example, a firm is trying to penetrate a market, it will be inclined to determine its fees based on those of its competitors in that particular market. For the most part, firms that follow a market penetration pricing strategy will tend to charge lower fees than their competition.

Philip Kotler writes that low fees are advisable when one of the following four conditions exists:

1. The market appears to be highly sensitive to fee levels and, therefore, a low fee will stimulate more rapid market growth.

2. A low fee would discourage actual and potential competition.
3. A low fee would not be viewed by clients as an indicator of poor quality work.
4. The more experience the firm obtains, the lower its costs of attracting and servicing clients.<sup>1</sup>

**Market-Skimming Pricing.** This strategy is normally used when a new or improved product comes out and the producers know that there will be a small section of the market that will be willing to pay a premium price to be one of the first in the market to have the product. This pricing works well when the demand for the product or service is high and the relative supply is low. If a new medical technique becomes available, it could be priced using this strategy. Firms will try to make a large profit from a small number of clients. As more and more providers of the service enter the marketplace, this strategy becomes less attractive. Firms recognize that they can make high short-term profits. Unless your firm offers a unique service, or unless you have developed an extraordinary perception in the marketplace as an expert in a certain unique area, you probably won't be able to utilize this strategy. For example, there are a number of local firms that have created some unique profit improvement consulting techniques geared toward specialized industries. Since no one else in their marketplace currently has such a service, these firms are charging a premium price.

**What the Market Will Bear.** Most other professionals today price their services based on what the market will bear. Think for a minute about the following professionals: physician, real estate broker, life insurance broker, stock-broker, business broker. What do they all have in common? Their fees are not based on hourly rates — rather they are based on the relative value or complexity of the medical procedure, the size (amount) of the real estate transaction, the premium of the life insurance policy, the number and value

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<sup>1</sup> Philip Kotler, *Marketing Management*. Englewood Cliffs, NJ: Prentice-Hall, 1988, page 168.

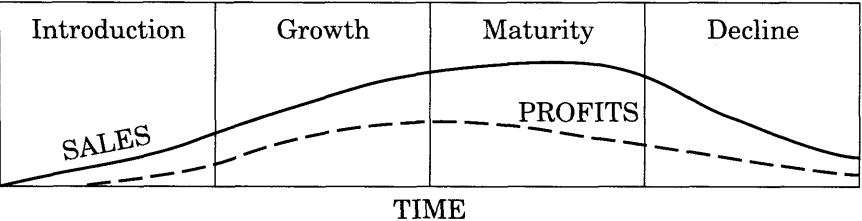
of the stocks bought or sold, and the value of the business bought or sold.

Pricing is a sophisticated technique that is given a lot of thought and attention by most other industries. In a buyer’s market, pricing was dictated more by the buyer than by the seller. Conversely, in a seller’s market, the providers of the service and products could set their prices a little higher. And at different times, nonprice factors became more important than the straight price. These nonprice factors over the years have ranged from pure advertising, customer service, quality, service guarantees, distribution of the product or service, sales personnel, and offers of customer credit. In addition, in the accounting profession, the accountant–client relationship is often a key factor in obtaining a premium fee.

THE PRODUCT LIFE CYCLE

There is an important marketing concept that provides companies with tremendous insight into what they can expect for their products in the marketplace. It is the product life cycle and, sooner or later, all products will go through the complete cycle. As they do, several external and internal factors change. The accounting industry and the services it provides are no different. Figure 2.1 displays the life cycle for a typical service or product.

Figure 2.1 Product Life Cycle



As figure 2.1 shows, the product life cycle is divided into four distinct phases: introduction, growth, maturity, and decline. The most important thing to remember about the product life cycle is that it is intimately tied into the sales of the product/service. It is important that a firm’s marketing

mix change during the life cycle of its various products. Firms that recognize which stage their different services are in are better off in identifying forthcoming opportunities as well as threats. For example, the marketing mix of audit services that are in maturity need to be much different than those for optical scanning service or some other recently introduced consulting service.

## **Introduction Phase**

In the introduction phase, sales are normally low because the marketplace is still unaware of the service. Your marketing emphasis should be on informing prospective clients of the benefits of the service. A lot of money will need to be invested in promotion in the hope of future profits. Often, during the introduction stage, companies take one of two approaches. They either roll out the product or service using a skimming strategy or they use a marketing penetration pricing strategy in order to obtain the largest market share. The latter strategy makes sense if the market is large and buyers are very price-sensitive.

## **Growth Phase**

Once past the introduction phase, a product enters stage two, which is the growth phase. If a product reaches the growth phase, there is a rapid climb in sales. Profits as well as sales increase. The number of competitors also rises in this phase. Usually, the first one in the marketplace reaps the largest rewards, but it is not uncommon for others to copy those who are successful. A number of firms fail to see the impact of competition on future sales and profits in this cycle. The new competitors often bring enhancements to the original product or service, thus creating new opportunities and expanding the market even further. Since demand for the product or service is increasing in this stage, prices usually stay where they were in the introduction phase or fall slightly. Profits, however, rise significantly. Usually, toward the end of this phase, a company will lower its prices in order to attract a new group of buyers.

## Mature Phase

In the mature phase, there are many competitors, and sales and profits begin to level off. Many producers cut prices in an attempt to capture a larger market share. In the introduction phase, a firm can ask for a premium price because there is little if any competition. In contrast, the mature phase is characterized by a lot of price dealing and cutting. In the mature phase, you will find new services replacing older ones and some services completely disappearing. Change is the one constant in the product life cycle.

The accounting profession, as we know it today, is undergoing accelerated, if not exponential, change. The profession has changed more in the last fifteen years than in all the preceding years of its history. Equally important, the mainstay of the accounting profession, attest function work, is in the last stages of the mature phase of the product life cycle. As a result, revenues from these services continue to shrink year after year, while revenues from various consulting services that are in an introduction or growth stage continue to increase.

The identifiable effects of a late mature market are the same for any kind of service or goods, and will be discussed below.

**Consolidation.** In the mature phase, normally, there is a consolidation of providers. We have already witnessed the Big Eight become the Big Six, as well as the complete disappearance of many other regional firms. The consolidation of accounting firms is likely to continue well into the twenty-first century.

**Brand-Name Recognition.** The Big Six firms have already achieved brand-name recognition, at least among the Fortune 500 companies. Many regional firms, such as those in the McGladery Network, are in the process of creating such name recognition. Several accounting and tax franchises already exist and are developing brand-name recognition. Who hasn't heard of H&R Block? The power of brand recognition becomes a critical marketing factor in the mature phase of the product life cycle.



**Price Competition.** Price competition among the largest accounting firms started in the late 1970s and early 1980s and probably contributed to the Big Eight turning into the Big Six. Price competition started with high-end audits and today permeates all compliance services. With the massive layoffs of Big Six partners and the increased numbers of sole practitioners, price competition is now ubiquitous, no longer restricted to audits of major publicly held companies. Technology and a sophisticated client base have also added to price competition.

**Increased Involvement in Marketing.** Because of increased competition, businesses that operate in a mature market need to spend more time and money on marketing and business development. Whereas ten years ago accounting firms spent very little on marketing, today it is not unusual for them to spend from 2 percent to 8 percent of their net fees on marketing.

**Competition From Outside the Profession.** There are new service providers today. Accounting firms offer only one unique service to their clients — the attest service. All other services that accounting firms provide today can be obtained from other sources, such as lawyers, systems consultants, financial planners, and employee benefits consultants. Many other financial services providers have seen additional pressure from overseas competitors. Can the accounting profession be far behind?

**Sophisticated Buyers.** In today's marketplace, clients are selecting accountants on the basis of the impact the accountant may have on their business or personal life. It is not unusual for clients to work with more than one accounting firm for different services. More and more clients are asking for proposals, some even on a yearly basis.

The pressures that the accounting profession is experiencing today will only increase in the future. In the mature marketplace, clients will have a broader choice and it will become more difficult for firms to differentiate themselves on the basis of price, range of services, and niche expertise. Differentiation based on perception and brand name will become more important. But the firms that will truly be

successful are the ones that concentrate on the quality of service, product, processes, and communication. Research shows that clients will impute value when these factors are effectively combined.

## **Decline Phase**

The last phase in the product life cycle is decline. This is a period when sales show a strong downward movement and profits are slim. The typical pricing strategy that firms employ in this stage is price cutting. It appears that the product life cycle is accelerating for many products today. Perhaps the main reason for this is the rapid advancement in technology. Just think for a minute about the product life cycle of 78-rpm records, 33-rpm records, eight-track tapes, cassette tapes, CDs, and micro CDs.

The other major element that causes decline is a shift in customer attitudes and behavior. The accounting profession has not yet reached this stage, but it would be foolhardy to think that it never will. Firms need to begin the process of thinking about the future in order to develop a well-thought-out plan for handling this potential danger. Some of the Big Six firms are currently doing so by developing service improvements, repositioning their services, looking for new distribution outlets, and developing new uses for traditional services, for example, getting law firms to out-source their accounting functions to CPA firms.

## **DEMAND**

Economists define *demand* as a schedule of the various amounts of an item that buyers will purchase at different prices during a given time period. According to the theory of price elasticity of demand, there is an inverse relationship between price and the quantity of an item bought. In other words, as the price of a service decreases, the quantity demanded increases, and as the price of a service increases, the quantity demanded decreases. This author is not aware of any published studies that would estimate the demand of a given accounting service. It has been difficult for most

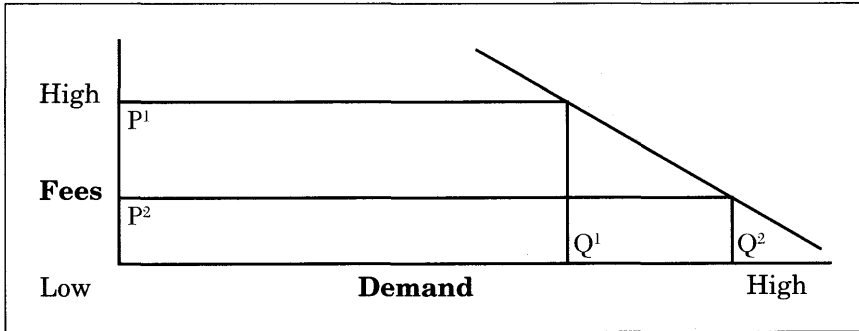
accounting firms to accurately estimate the demand for their services. A critical aspect of pricing is the elasticity of demand or the responsiveness of your clients to a change in the pricing of your services. Demand can be either elastic or inelastic. If demand is elastic, a decrease in your fees will result in an increase in demand and an overall increase in total revenue. If demand is inelastic, a decrease in your fees — even a significant decrease — may have little positive effect on the demand of your services, thus resulting in a decrease in overall total revenue. Inelasticity also exists when the price increase times the quantity demanded results in an increase in total revenue.

In the accounting profession, it appears that the demand for most services is inelastic. For example, many firms that have raised fees have found that the quantity has decreased slightly, but that overall revenue has increased. A firm could determine the market size for a given service and then price that service accordingly to the increased demand for its service at a given price. In other words, you find out that 300,000 corporate tax returns were filed last year in your market. If you think you are in an area with elastic demand you will want to lower your fees. This will increase demand for the service and give you a greater total revenue. If you believe that you have inelastic demand, then you would want to raise your fees, which, in turn, would lessen the demand but provide you with overall greater revenue.

Obviously, demand will be completely different in each market and for each service. For example, the demand for compliance work in accounting shrinks in direct proportion to the number of mergers that take place each year. Conversely, if the economy in your area is growing and new businesses are being formed, then you will experience a greater demand for those services.

Figure 2.2 demonstrates the elasticity of demand. In other words, if the price of your service ( $P$ ) is lowered and that results in a more substantial change in the quantity purchased ( $Q$ ), the demand for your service is elastic. The elasticity of demand for accounting services usually depends on three factors:

1. If your service is perceived as something that would be nice to use, but that is not necessary, then the demand

**Figure 2.2 Elasticity of Demand**

will be elastic. Examples of such services include consulting projects that are not critical to the current operations of the business and other kinds of services, such as estate planning, that can easily be put off.

2. If your service is an important part of your current clients' and prospective clients' budgets, the demand will be elastic. The more important it is to your client's operations and the greater the cost of the service is to your client's overall budget, the more responsive the demand will be.
3. Finally, if there are few acceptable substitutes for your services, then the demand will be inelastic.

Many times, clients postpone the purchase of a service that is not critically necessary. By lowering the fee for these services, you may increase the demand. Many businesses try to stimulate demand for a service by offering some sort of discount or special offer. If, as my experiences have shown, the demand for most accounting services is relatively inelastic, then accountants must use other marketing tools, such as service differentiation or direct sales and promotion, to increase and stimulate sales. Nonprice, rather than price, competition is the most effective way to increase the sales of a service if the demand for the service is inelastic.

## COMPETITION

Perhaps the next most important marketing factor affecting an accounting firm's pricing policies is competition. As

clients and prospective clients become more sophisticated and cost-conscious, pricing becomes more important and more firms are beginning to stress the price of their services. Intensive price competition is now a way of life in most major service industries from hotels to airlines, from car rentals to telecommunications. Can the accounting profession be far behind?

From a theoretical point of view, there are four models of competitive market structures that you need to be aware of: perfect competition, monopolistic competition, oligopoly, and monopoly.

## **Perfect Competition**

A perfectly competitive market structure would involve a large number of service providers, all providing the exact same standardized service. No major obstacles would prevent firms from entering or leaving the market and no one firm would be so large as to have control over price. This model also assumes that the buyers have complete knowledge of all services offered for sale. One could make a case that sole practitioners and other small accounting firms would fit into this model. There are very few barriers of entry for a sole practitioner who is setting up shop. In fact, many accountants start out working from their homes or renting or sharing an office. Since the smaller firms are basically providing the same services with very little differentiation, they are under tremendous pricing pressure and compete more on price than on anything else.

Most larger accounting firms operate in either a monopolistic market or an oligopoly.

## **Monopolistic Market**

The monopolistic market structure includes many sellers who try to distinguish their services so that they have some control over the prices they charge. In this type of environment, firms differentiate themselves and their services according to the following:

1. Location
2. The reputation of both the firm and individual partners within it

3. Specialized skills
4. Any other attributes that make a firm different, including high-impact services, industry specialization, computerized auditing, and technological advantage

The majority of small and medium-sized firms conform to this model. Rather than competing on price alone, these firms attempt to add value and differentiate their services through niche development and other activities.

## **Oligopoly**

In an oligopolistic market structure, there are few service providers. Often, there are significant barriers of entry for new competitors. For example, there are situations in which the Big Six and other major, national firms will be the only competitors; smaller firms will simply not be contenders. In a traditional oligopoly, price is not used extensively as a marketing tool, although some would argue that price has been a significant marketing tool for the major firms. Granted, you will observe deep discounting in proposal situations, but it would be difficult to find an advertisement or other promotion piece that claims Arthur Andersen & Co. or Coopers & Lybrand provide their services at discounted prices.

## **Monopoly**

Monopolies do not exist in the accounting profession. No matter what the niche or the service required, not one firm in the country offers a unique service. Actually, antitrust laws in the United States prohibit all monopolies.



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**Chapter 3**

**Utility and Value:**  
**How They Affect Pricing**

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**I**f, indeed, we believe the phrase “perception is reality,” then it is the client’s perception that is the only reality. Ultimately, only a client can determine the value of your service, that is, the fee he or she is willing to pay. If the client perceives that he or she has received a benefit or utility, some perceived value will be attached to the service. Consciously or unconsciously, the client’s determination of the correct fee for a service is related to two concepts: *utility* and *value*. Let’s look at these two concepts and how they apply to setting prices.

## HOW CLIENTS PERCEIVE UTILITY

Utility is often defined as the ability of a service to satisfy the needs or provide the benefits that the client or prospective client is seeking. It is the utility or benefits of a service that ultimately determines its value. The greater a service’s utility is to the client, that is, the more it satisfies a client’s needs, the more the value of the service to the client. Utility increases value, and value is then translated into the price that someone is willing to pay for a product or service.

A client can receive six kinds of utilities from a firm that offers, for example, accounting, tax, or business consulting services. Each is discussed below.

1. *Form utility* is created by making a service available in the right form. For example, a client may be looking for a firm that offers an electronic income tax filing service. If your firm offers that service, you would be providing a form utility. Another client might expect his or her accountant to be able to prepare his or her quarterly financial statements from information submitted on a disk. If your firm was not able to accommodate this client, you would probably lose the client because form utility was not being met.

2. *Place utility* is created by making a service available for purchase in the right place. A firm that has multiple offices in a region offers clients more place utility than a firm with a single office. If you are competing in a broad geographical area, place utility becomes important.
3. *Time utility* is created by making a service available at the right time — in other words, when the client needs it. Time utility is also known as responsiveness. Time utility usually occurs at two levels. The first level of time utility addresses being able to respond to a prospective client's request for a proposal or starting an engagement when the client is ready. The second level addresses the ongoing responsiveness of you and your staff to the client's needs, items such as promptness of returning telephone calls or delivering a tax return on or before the promised date.
4. *Possession utility* only happens if the client receives the service. For example, possession utility occurs if the client actually has in his or her hands the monthly financial statements, the budget or projections, or the draft of the tax return.
5. *Change utility* occurs if the services create a change in the client's physical, emotional, or spiritual well-being—for example, a tax-planning service increases a client's wealth or an estate plan provides a client with more peace of mind.
6. *Expectation utility* addresses the relationship of actual service outcome, timing, and cost compared with the client's expectation. Expectation utility can be either positive or negative.

These various utilities all enter into the perceived value of the service provided.

## HOW CLIENTS PERCEIVE VALUE

Although we hear and read a lot about value, it is one of those terms that seems elusive. What one person considers a value, another may consider a great expense. For example, what is the value of a business? Is it a future stream of cash

flow? Is it some multiple of current sales? Is it the price that you would get on an auction block, or is it merely the price that a willing buyer would pay for the company?

In his 1992 book *Win-Win Billing Strategies: Alternatives That Satisfy Your Clients and You*, Richard C. Reed defines value as “the measure of what benefits the client perceives have resulted”<sup>1</sup> from the accountant’s effort. From this standpoint, the value of any service is what the client is willing to pay for the perceived benefit that he or she has received. The emphasis is on the word *benefit*. Client-centered firms realize that they have to understand the client’s perception of the firm’s services and the benefits they receive from the services. A basic shift in our focus needs to take place. The shift is from the service we provide to the benefit the client receives. This is the first step in moving away from the hourly billing paradigm and creating a new pricing paradigm wherein we learn how to place a value on the benefit that a client receives and bill for the value of that benefit accordingly, irrespective of the time spent.

The fee charged is really nothing more than the exchange value of the service provided. That exchange value is determined by the client. Clients will tend to pay whatever they believe a service is worth. If clients think that the fee for a particular service is too high, they will not buy it. If this happens, you generally have two choices — either lower your prices or lose sales. After all is said and done, the value of a service is established by the marketplace, which also includes the impact of competitors’ prices and the overall demand for the service. Fee evaluations by clients are also influenced by other factors, such as competition, perceived expectations, what they are used to paying for a similar service, and even the psychological makeup of the client.

When I ask clients how they perceive the value they receive from services, they give answers that are consistent with the conclusions that can be drawn from client satisfaction surveys that I have conducted. The four main perceptions are the following:

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<sup>1</sup> Richard C. Reed, ed. *Win-Win Billing Strategies: Alternatives That Satisfy Your Clients and You*. Chicago: The American Bar Association, 1992, page xx.

1. *Clients will feel that there is value to your service if it adds value to what they already have.* For example, did your service save the client from paying additional taxes? Did the computer system you suggested improve productivity or efficiency? Did the estate planning advice you provided reduce estate taxes? The more your clients feel that you have added value to something they already possess, the higher your fees can be.
2. *The better you understand a client's needs, the more value there will be to your services.* Clients tell us that the accountant who really understands not only the client's business needs but also his or her personal needs (as well as their interrelationships) is very valuable.
3. *If the service does not add value to an existing asset of a client, then does it save the client from an unpleasant or costly situation?* For example, a corporate client receives notice from the Internal Revenue Service (IRS) that it will have to undergo an audit. Because of your advice and representation before the IRS, the client does not have to pay any additional taxes. In another example, two physicians want to dissolve their partnership. You represent one of them and assist this physician through the entire process, saving the physician not only a great deal of money but also much mental anguish.
4. *Value is also determined by the current supply and demand situation.* As we discuss later in this chapter, unique services have more value. Tax planning services have a higher value than tax compliance services. Even in the compliance area, the preparation of Form 1040EZ will have less value in the eyes of the client than a complex return, which has several schedules.

There are things that you can do to help your clients perceive a higher value for you and your services. These are not activities that can immediately allow you to increase your rates, but, if done consistently, they will reinforce to your clients the added value that you bring to them. Innovative firms realize that it takes more than just a seminar or a newsletter to provide added value to the client. Everything revolves around the personal relationship that ultimately develops between the accountant and the client. Exactly

what is that relationship and how does it translate into higher fees? Everything that you do for a client ultimately has to have an impact on the client’s future, his or her personal success, the profitability of his or her company, the security of his or her estate, and so on.

Completing the questionnaire in exhibit 3.1 will show you how much added value you are currently providing to your clients.

**Exhibit 3.1 Value-Added Questionnaire**

Consider the following ways that value can be added to your services. For each statement, rate yourself and your firm as to how well you do. If you are doing an outstanding job, give yourself a 10; if you are doing an extremely poor job, give yourself a 1. Most likely, you will rate yourself somewhere between these two extremes. Any questions that receive a rating below 7 or 8 should be reviewed carefully to see how you could improve the rating.

	<u>Myself</u>	<u>My Firm</u>
1. I am always straight-forward with my clients. If nothing needs to be done, or if there is a less expensive way to proceed, I tell them.	_____	_____
2. I am able to control my clients and prevent them from taking inappropriate actions because of my experience and maturity of judgment.	_____	_____
3. I provide my clients with profit-generating ideas.	_____	_____
4. I will guarantee total client satisfaction with my services.	_____	_____

(continued on next page)

**Exhibit 3.1 Value-Added Questionnaire (continued)**

	<i>Myself</i>	<i>My Firm</i>
5. I am able to supply my clients with a high level of expertise and skill which is either my own or acquired through my network of other professionals.	_____	_____
6. I have certain skills, such as negotiation skills or valuation expertise, that are hard to find elsewhere.	_____	_____
7. I care about my clients' needs and regularly provide support.	_____	_____
8. I regularly provide timely services.	_____	_____
9. I provide advice that shields my clients from risks, such as IRS audits, estate planning problems, or installing the wrong computer.	_____	_____
10. Because of my personal standing in the community as a highly regarded accountant, I bring an added value to my clients' credibility.	_____	_____

**VALUE AND THE SERVICES PROVIDED**

There is a completely different way of looking at value and it is tied into the kind of accounting work that is available in any given market and the kind of accounting work that your firm provides. William C. Cobb, in his 1989 article “The Value Curve and the Folly of Billing-Rate Pricing,”

provides a great deal of insight into the concept of pricing and value.<sup>2</sup> Many of the ideas that follow are based on this article. In discussing legal services, Cobb notes that sophisticated clients do not tie benefits to hours. Rather, there are certain types of services that have a significant impact on the client's business. The key words here are "sophisticated" and "impact." More and more of our clients are becoming sophisticated and most clients are looking for impact services rather than pure commodity-type services. As we shall see in figure 3.1, any service that is beyond the commodity range can be considered to be an impact service. I would define a commodity service as one that has little or no real value to the business or its owner. For example, the preparation of a 1040 tax return would be a commodity service, while tax planning time would fall under the category of "impact." Unique services are impact services. (If you deal mainly with unsophisticated clients, you may have more difficulty implementing many of the ideas in this book, unless you spend a lot more time educating your clients. Or, you can determine what type of impact services you can provide them.)

## The Value Curve

Figure 3.1 illustrates Cobb's value curve. At the top end of the curve are ultimate impact (or unique) services — that is, services that add value to the client and that the client needs and wants. At the other end of the curve are those services that *must* be performed in the course of getting the work done. These can include monthly write-up services, payroll tax, and other types of compliance services. In reality, they add little or no value to the client's business and the client generally will not value them on the basis of the number of hours that you spend. In fact, the client probably does not care how much time you spend. In other words,

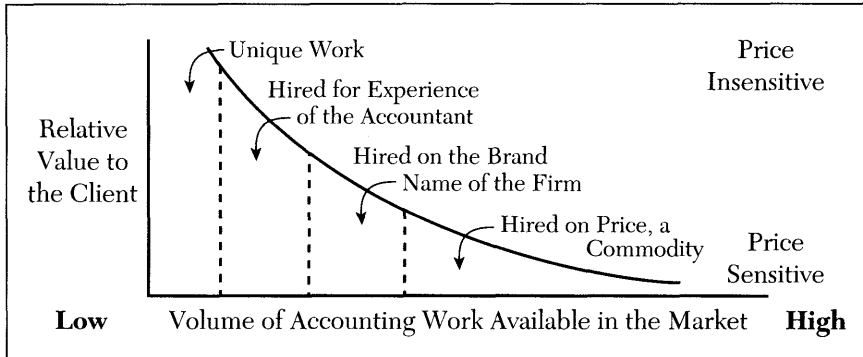
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<sup>2</sup> William C. Cobb, "The Value Curve and the Folly of the Billing-Rate Pricing," in *Beyond the Billable Hour: An Anthology of Alternative Billing Methods*, Richard C. Reed, ed. Chicago: American Bar Association, 1989, page 18.



value in the client's eyes has no relationship to the hours that you may put into the effort.

**Figure 3.1 Value Curve**



SOURCE: Adapted from William C. Cobb, "The Value Curve and the Folly of the Billing-Rate Pricing," in *Beyond the Billable Hour: An Anthology of Alternative Billing Methods*. Richard C. Reed, ed. Chicago: American Bar Association, 1989, page 18.

Cobb has created this value curve for legal services, but, as we will see, it applies equally to accounting services. The value curve shows the relative value of services versus the volume of the work available to an accounting firm. According to Cobb, the higher the available volume, the more price-sensitive the service. Like an attorney, an accountant must look at the kinds of accounting or consulting services that he or she delivers in relation to the competition in the existing market. Different kinds of services fall at different points along the curve.

### **Categories of Services on the Value Curve**

Cobb asserts that the volume of legal work available in each market breaks down into four main categories. This categorization also applies to the accounting profession. The four categories are discussed in the following sections.

**Commodity Services.** Cobb states that 60 percent of the total legal work available in a given market will fall under this category, and the same is probably true for accounting work. In the accounting profession, commodity services include write-up work, payroll, and simple tax returns. In

the client's eye, any good accountant can do this kind of work. In addition, an abundance of service providers do this work, which, in turn, maintains a lot of pressure on the fees.

**Brand-Name Services.** This work is more routine but is important to the client. Clients requiring brand-name services will go to the firm that has established a position in that particular area. For example, clients that require corporate finance or Securities and Exchange Commission (SEC) services will most likely look to one of the Big Six firms. A local or regional firm that has developed a certain niche (for example, automobile dealerships, nonprofit accounting, real estate, or health care) would also fall under the brand-name services provider category.

Firm size and reputation are important factors. To achieve this kind of recognition firms will have to spend a great deal on advertising and other kinds of nonpersonal promotional activities. About 20 percent of the total work available in a given market is brand name. Most small accounting firms do not have extensive brand-name recognition. The Big Six accounting firms certainly do, as do some of the larger local firms.

**Experiential Services.** This is a high-impact or high-risk matter for the client. The client will give it to the lawyer or accountant that he or she believes has extensive experience in the area, such as real estate services, and will personally handle it. Firms that specialize in litigation support are often hired because of the experience of one of the partners. About 16 percent of the work available in a market is experiential in nature. The competition in this range is very limited. Of all the accountants in your area, how many would actually qualify for this kind of work? Obviously, not many. Because of this, you will be able to charge a premium rate.

**Unique Services.** Unique services can often address a life-changing event for the client. Succession planning in a crisis situation, major tax litigation, the danger of bankruptcy, or complex merger and acquisition strategies are examples. For unique services, the client will seek the firm and the individual that he or she feels will best meet his or

her needs with little or no concern for the price of the service. Many times, these services are called for in life or death situations. In these circumstances, the client does not care what it will cost to solve the problem; the most important thing is that it be resolved. Less than 4 percent of the work in a market is unique.

## **Other Considerations When Using the Value Curve**

Cobb goes on to make several statements about the legal profession that again also apply to the accounting profession. Let's look at each of them.

First, according to Cobb, not all work should be done with the average leverage of partners to staff. The mix will be different depending upon the kind of service provided. A large audit will require a greater number of staff performing lower level work than a more sophisticated merger analysis, which requires specialized skills from a senior partner. There is no leverage with the merger work and the weighted average billing rate will be higher than in the audit engagement.

Second, since most firms develop their billing rates based on overhead, most professionals of a similar status carry the same billing rate. There is a basic assumption that all work will be performed at or better than the average leverage. As we saw above, the partner who is working on the merger engagement should have a much higher billing rate than work that the same partner might do on the audit engagement. There is a critical implication here regarding the work that a partner does that is below the average billing rate and that for the most part should be done by people with lower billing rates. If clients perceive that the work being done by the partner falls into the commodity area of the value curve, one thing will surely happen. The client will eventually leave the firm or require that the fees be adjusted downward. In most cases, the client leaves the firm because another less expensive, more efficient firm will come along.

Third, having just one billing rate for all your services causes another problem on the value curve. All commodity services (any type of compliance service) will be overpriced.

As competition increases and clients become more sophisticated, clients will continue to perceive these as low-value services. To compete in this market, the firm will either need to reduce its overhead, develop more efficient systems and procedures to get the work out, or learn how to better manage the engagements. If the firm cannot do any of the above, then it will ultimately have to discontinue that service. We are witnessing this today both inside and outside the accounting profession. With the recent downsizing of corporate America, many firms have given up the smaller end of their market since they can no longer service it profitably. Of course, a firm can always decide to continue to offer a service at a loss if they consider it to be a loss leader, that is, a feeder for more profitable work.

There are firms that are quite profitable doing work at the low end of the value curve. Through proper staffing and efficiencies, these firms are able to reduce the cost of the service for the client and realign the cost-benefit ratio. Because of proper staffing, there are lower staff costs, fewer write-offs and realization increases. In addition, with efficiencies from technology, especially current tax preparation software and refined processes, these firms can add even more profits to their bottom line. And, certain resources of the firm (that is, partners and senior managers) have more time to work on matters more valuable for the clients.

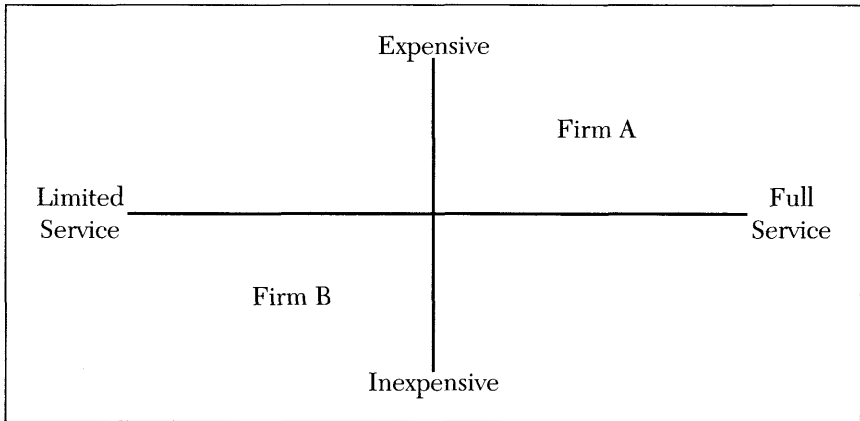
## Using the Value Curve to Define Market Position

The value curve, as Cobb notes, can also be used to develop marketing strategies. The number one issue that most accounting firms face is how to differentiate themselves from all of the other firms in their market. This can be accomplished by positioning yourself or your firm in one or more areas on the value curve. It is unfortunate, but true, that in the minds of most clients there is little difference among most accounting firms. One way to differentiate your firm is to create a market position, or *personality*. Figure 3.2 is a traditional positioning grid (sometimes referred to as a product space map) that you can use to determine your clients' perception of your firm and your competitors. This is no different than when you walk into a supermarket look-

ing for a box of cereal. Do you want a high-fiber, low-sugar variety, or are you interested in high sugar and no fiber? You can imagine your confusion if you could not tell the difference between the boxes. You should be able to develop a perceptual space map that indicates where clients in a segment perceive the position of the different competitors.

In addition to the four items listed, the firm can also be described as aggressive or nonaggressive, innovative or conservative, providing timely service or late service, offering good value or poor value, having a good reputation or a poor reputation, being a high-prestige or low-prestige firm, local or regional.

**Figure 3.2 Traditional Positioning Grid**



Given the various attributes cited above, where would your clients place you on this grid? Is it the same place that you would place yourself? If you gave two different answers, do you want to be where you are? If not, what do you need to do to change your position? For example, if you want to be known as a full-service firm but are not, then you may have to develop a more complete line of services. This may require a merger. Or, if your firm is considered inexpensive and you want to move up on this axis, then you might need to provide higher value services to your clients. Selecting your positioning strategy is clearly a marketing task. It reflects your firm's "personality" and clients should be able to distinguish one firm from another. I know a local firm that has decided to position itself as innovative and aggres-

sive, and everything this firm does supports this image, from its brochures to the kinds of professionals it hires. Another firm in the same locale has positioned itself as the Mercedes Benz of accounting firms. It is more conservative, seeks to serve established businesses, and charges a premium fee.

When all is said and done, it is the client who ultimately tells us what our position in the market really is and what our value is in relationship to other service providers.

As you now know, pricing — that is, fee-setting — is, above all, a marketing decision. Valuing services needs to become an important part of your daily routine. We can look at hourly rates as just part of the evolutionary development in the development of the accounting profession. Other things in the profession have come and gone; so will the hourly rate. If you are not in the front leading the change, then be prepared to be behind, in more ways than one.



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# **Chapter 4**

## **Alternative Pricing Methods**

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**I**n the old days, you could go into a shoe store and purchase gym shoes or sneakers. Nowadays, there are tennis shoes, running shoes, walking shoes, aerobic shoes, basketball shoes, soccer shoes, and the list goes on and on. Perhaps the billable hour paradigm will go the way of the gym shoe. Accountants need to realize that in pricing their services, one pricing method will no longer do. As with athletic shoes, accounting and consulting services can be priced in many different ways. This chapter will explore ways for you to move away from the hourly billing paradigm.

## **ETHICAL PRICING ISSUES**

Many professionals believe that pricing arrangements other than on a fee per hour basis are unethical or illegal. It is necessary, therefore, to make the following distinction: If someone is going to be unethical, it will not be a result of the billing method he or she uses. There is no intent here to encourage or suggest unethical billing; without question, charging a client for six hours of work when only four hours were performed is unethical.

Independence and objectivity are the two key elements that are of the most concern to accountants when they think about alternative pricing methods. Commissions, contingency fees, success fees, and the like can be acceptable in some cases as long as —

1. The client is aware of the pricing arrangement before the start of the engagement.
2. The arrangement complies with the rules of conduct of the AICPA and the relevant state CPA society and state board of accountancy.

## Discussion of Rule 302, “Contingent Fees”

The AICPA defines a contingent fee as “a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.”

The following is an extract from the AICPA Code of Professional Conduct, Rule 302, “Contingent Fees” (AICPA, *Professional Standards*, vol. 2, ET sec. 302).

A member in public practice shall not

(1) Perform for a contingent fee any professional services for, or receive such a fee from, a client for whom the member or the member’s firm performs

- (a) an audit or review of a financial statement; or
- (b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member’s compilation report does not disclose a lack of independence; or
- (c) an examination of prospective financial information; . . .

Although the above list does not include all attest services, for simplicity a client receiving these services is hereafter referred to as an attest client.

This prohibition applies during the period of the professional engagement and the period covered by the historical financial statements.

Rule 302 also prohibits the preparation of an original or amended tax return or claim for tax refund for a contingent fee for any client. However, in tax matters, a fee is not regarded as being contingent if it is determined based on the results of a judicial proceeding or the finding of a governmental agency.

There are many examples in which a contingency fee would be acceptable under the current ethical guidelines, for example, representing a client in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute; the selling of a business for a nonattest client in which a fixed fee will be charged only

if the transaction is successful; or the performance of an executive search if the price of the service is based on the success of finding the right candidate for a position. As long as the service does not occur or the fee is not received during the prohibition period described above, the firm could charge this client a contingent fee for performing any of these services.

## **Discussion of Rule 503, “Commissions and Referral Fees”**

Considering the multiple service relationships that many professionals have with their clients, a situation may arise whereby the professional is asked to perform a commission-based service. For example, a tax client may ask his or her CPA to provide investment advice. As with contingent fees, the CPA may receive a commission with respect to such advice as long as he or she does not perform any of the following for the client:

1. An audit or review of a financial statement
2. A compilation of a financial statement when the member expects or might reasonably expect that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence
3. An examination of prospective financial information

However, the receipt of a permissible commission must be disclosed to the client when the performance of the service is complete and the fee is determined.

A CPA may accept a referral fee for recommending any service of a CPA or pay a referral fee to obtain a client provided such a fee is disclosed to the client. At the time of the writing of this book, sixteen states allowed CPAs to accept commissions. These states are Alabama, Colorado, Florida (where the state allows commissions under a separate business act), Illinois, Indiana, Kansas, Maryland, Minnesota, North Dakota, Ohio, Oklahoma, South Dakota, Texas, Utah, Vermont, and Wisconsin.

## SUBJECTIVE PRICING FACTORS

As we have seen, accountants may face only two major restrictions in determining their fees — the restriction against contingency fees under certain circumstances and the taking of commissions or referral fees. We have also seen that for the most part, accountants bill their time based on a cost-plus method. Our brethren in the legal field often look at the following twelve factors in determining the reasonableness of their fees.<sup>1</sup>

1. The time and labor required
2. The novelty and difficulty of the questions involved
3. The skill required to perform the service properly
4. The fee customarily charged in the locality for similar legal services
5. The monetary amount involved and the results obtained in the matter
6. The experience, reputation, and ability of the lawyers and the firm performing the service
7. Awards in similar cases
8. Whether the fee is fixed or contingent
9. Nature and length of the professional relationship with the client
10. The “undesirability” of the case
11. Time limitations imposed by the client or the circumstances
12. Preclusion of other employment due to acceptance of the case

According to the AICPA's *Management of an Accounting Practice (MAP) Handbook*, there are nine subjective factors that can affect an accountant's fee. Many of them are simi-

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<sup>1</sup> Richard C. Reed, ed. *Win-Win Billing Strategies: Alternatives That Satisfy Your Clients and You*. Chicago: American Bar Association, 1992, page 26.

lar to the preceding factors taken into consideration by attorneys. However, the unfortunate reality is that most accountants ignore these factors because they are so blinded by the billable hour paradigm. Ask yourself whether or not you took any of the following nine elements into consideration when you were determining your fees for your last new client.

1. *Skill and experience of the staff.* For engagements over 40 hours, most firms will develop a budget showing the time required by each level of staff. Staff who have added experience, additional years of service, for example, a manager who has been with the firm for eight years, or perhaps advanced degrees, such as an MST, should demand a higher billing rate.
2. *Responsibility assumed.* Special services, such as reports on the registration of securities with the Securities and Exchange Commission (SEC), and certain kinds of tax, management consulting, and specialist services merit larger fees.
3. *Value of the services to the client.* Often, the time expended in providing a service does not accurately reflect the value of the service received by the client. Perhaps the most obvious examples are the savings in taxes or in accounting costs derived from the installation of a new accounting system.
4. *Difficulty of the engagement.* Higher fees are justified if difficult and complex technical problems are handled by specialized partners and staff.
5. *Special considerations for new clients.* The firm's existing clients have paid, in part, for the experience acquired or for research materials contained in the files. A new client, who has not contributed to this accumulation of research materials, should pay as much as the existing client paid for these services even though, because of the earlier work, a smaller amount of time and effort is involved.
6. *Size and character of the community.* Higher fees might be appropriate in some engagements because living

expenses and operating costs may be higher in some communities.

7. *Working conditions.* Unsatisfactory client location or working conditions may warrant billing at above-standard rates.
8. *Ability to pay.* The AICPA's *MAP Handbook* addresses only the situation where a client cannot pay for the services needed. In that case, the accountant might defer a portion of the fee, reduce the fee, or terminate the relationship. Note that deferring a portion of the fee has independence implications and you should refer to ethics ruling no. 52 in the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 191) before taking this course of action.
9. *Acceptability.* There is little point in providing a service unless the accountant can reasonably expect to collect a fee.

In addition to the factors listed in the AICPA's *MAP Handbook*, the following are three additional factors that you may want to consider:

1. *Impact on the rest of the practice.* During the busy season, consider setting a higher fee, and set a lower fee during slow periods.
2. *Loss of access to other markets.* Some engagements may result in a conflict with other desirable engagements. If this condition exists, you should get a premium rate.
3. *Marketing awareness of pricing.* Note that if you allow a discount for one client, you will face a dilemma if other clients find out.

Just think for a moment what your pricing for the next new client might be if you took into consideration these twelve factors. In both the legal and accounting fields, the standard-rate price for services is coming under attack because the buyers of these services are more sophisticated as supply continues to overwhelm demand. Too many accountants are pursuing the same business. As a result, over the past several years, many kinds of discounting or variations of fee structure have taken place.

## ALTERNATIVE PRICING METHODS

There are many ways to price your services. Alternative billing methods in the legal profession have received much more attention than in the accounting profession. In fact, an entire publication has been issued by the American Bar Association (ABA) on this topic. I am aware of at least fourteen different approaches to billing that attorneys can use under different sets of circumstances. Obviously, each method has advantages and disadvantages as well as marketing and operational implications. I maintain that several of these methods can be used by accountants and consultants in accounting firms when billing clients. Let's explore some of these methods and discuss the various advantages and disadvantages of each one. The majority of the ideas that follow are based on chapter 9 in Richard C. Reed's 1992 book *Win-Win Billing Strategies: Alternatives That Satisfy Your Clients and You*.

### Fixed or Flat Fee

A flat fee is the price that will be charged for defined services. Many firms today will quote a fixed fee for the audit or other financial statement engagements. It is not always necessary to provide a fixed fee for the entire engagement. Often, just one part of it may be quoted on a fixed-fee basis. Most accountants dislike a fixed-fee pricing strategy for fear that they will lose money. More and more clients, however, are asking for fixed fees in their request for proposals (RFPs) as a way to control expenses. We definitely need to get accustomed to this trend. It doesn't look as if it is going to go away.

**When to Use.** Fixed fees are called for whenever clients ask for them in their request for proposals. Larger corporations, in requesting audit proposals, often ask for a three-year bid, with fees fixed for each of the years.

Fixed fees are appropriate for commodity services in a highly competitive market. Smaller accounting firms often offer a package deal to their write-up or bookkeeping



clients. For a fixed fee, these firms will maintain the company's books and prepare the year-end tax return.

Use fixed fees for volume work on a repetitive basis. Often, when a firm is doing certain kinds of governmental grant audits, low-risk work, or repetitive engagements, fixed fees may be appropriate.

Finally, use fixed fees for routine services where experience shows that there will be very few variations from what it normally costs to provide the service.

**The Marketing and Operational Perspective.** The client knows what the fee will be up front. There will be no surprises and the client will be better able to control costs. A fixed fee also eliminates any of the problems that clients may currently face with billing. You, on the other hand, need to know the total cost of providing the service. If not, you run the risk of having unprofitable engagements because of cost overruns.

This billing method encourages the use of billing systems to track, monitor, and manage engagements; the emphasis on technology; and the ability to leverage and properly allocate human resources. It also can prevent partners from doing more basic work just to reach their billable time goals.

## Contingent Fee

As discussed on pages 60 and 61, rule 302 of the AICPA's Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 302) defines a contingent fee as "a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service."

Contingency fees in and of themselves are not bad. In a number of circumstances, they are perfectly ethical. In thinking about a contingent fee, remember that they may be combined with a fixed or flat fee or with an hourly billing rate.

**When to Use.** Contingency fees are most commonly used in merger and acquisition situations, in representing a tax-

only client in an examination by a revenue agent of the client's federal or state income tax return, in representing a client in connection with obtaining a private letter ruling, or in influencing the drafting of a regulation or statute. The reader should be familiar with rule 302 to make sure that he or she is not in violation of this rule.

Often, you may have the opportunity to represent a client for whom you are not providing any attest services. Or you may find it desirable to represent clients who need the service, but who otherwise would be unable to pay unless the transaction is complete.

This pricing strategy gives you the opportunity to accept only those engagements with a high likelihood of success. Firms that are successful in obtaining results for their clients will soon find that their expertise and reputation will attract additional clients looking for similar results.

**The Marketing and Operational Perspective.** Contingent fees entail little or no risk for the client. Unless the agreed-upon results are achieved, the client does not pay. It does require a perfectly clear understanding between you and the client as to the desired outcome.

This fee arrangement should get accountants to think about getting the best results in the least amount of time. This is not always the case, of course, under the hourly billing method. There is always the risk that you may spend more time than the engagement is worth; this is where you would want to combine the contingency aspect with an hourly element in order to protect yourself.

There is also a tremendous upside to this pricing strategy. It offers the accountant the opportunity to make a substantial amount of money in a very short period of time. For example, when buying or selling a business, most clients would pay according to a basic Lehman formula, which is 5 percent of the first million dollars, or \$50,000. At \$125 per hour, an accountant would have to work 400 hours to bill that amount. If clients work with business brokers, they expect to pay a commission or a success fee. Are the services that an accountant provides any different from a business broker? Is it wrong to ask clients to pay their accountant a similar value for the same kind of service?

## Hourly Rate

The hourly billing rate was intended to cover the cost of production plus a profit factor. The question is whether the hourly billing rate actually covers all the costs for a given client. Does your hourly rate capture the various disbursement charges and out-of-pocket expenses you incur to service the client? Most firms that use the hourly billing method also have a minimum time requirement. It may be as long as fifteen minutes or as short as five or six minutes. For example, an eight-minute phone call with a client would automatically be clocked as fifteen minutes. Other firms that use the hourly billing method have begun to use two billing rates. I have been suggesting to many firms to have at least two, and, in some cases, even three hourly billing rates depending on the service they are providing to their clients. Each billing rate could be 50 to 100 percent higher than the standard rate.

Over the years, clients have become comfortable with the hourly billing method. This method is also comfortable for the accountant because determining fees requires less work and thought at the outset, and the communication that is needed between the accountant and the client is minimized. This reduction in communication is not entirely positive, however, because it also reduces client satisfaction and increases client turnover. As a result, firms wind up spending more marketing dollars to replace business that is being lost.

One final aspect of hourly billing is that there are only so many hours in a year that a firm can bill. Therefore, the hourly billing method puts a cap on the total gross fees that can be billed in any given year. Not long ago a lawyer had billed 6,000 hours in one year. You can imagine the negative publicity this individual received!

**When to Use.** Some clients may demand hourly billing and will not consider anything else, even though the client may not know what the total fee will be. This is how they have always been billed and they need to be educated in the different ways of billing.

If you are doing consulting work as well as compliance work with clients, hourly billing may be appropriate. One

firm was able to increase per partner compensation by \$35,000 in one year by using dual hourly billing rates. The firm did a lot of auditing in a regulatory industry as well as high-level consulting that was not price sensitive. They had no trouble charging \$125 per hour for their compliance work and \$175 per hour for their consulting work.

In litigation services, the hourly billing method predominates.

**The Marketing and Operational Perspective.** The client is more at risk because he or she does not know the total fees that can be incurred. In fact, this method discourages efficiencies and any relationship between the fee and the value received.

Billing can be automatic, especially with a good time and billing system. In an ideal world, subjective judgments in billing are not required if you use this method. Detailed itemized invoices based on contemporaneous time entries are a chronology of work done and can be a means of communication (albeit a poor method of communication) between accountant and client.

## **Blended Hourly Rate**

In the legal profession, this method is becoming very popular with firms working with corporate counsels. Instead of using specific hourly rates for different individuals' time, one rate applies to all hours billed. This method is often used when the total time of the engagement cannot be established, but you do know the mix of people you will need to accomplish the task. In the accounting profession, this method is being used for audit proposals and other competitive situations.

Let me explain how you would determine a blended rate. As an example, let's say that you are quoting on a system integration project. You are not completely sure of the time it will take to complete the project. You do know that you will need a senior consultant at \$150 an hour, a manager at \$85 an hour, and a staff person at \$45 an hour. You estimate that the senior consultant will work 30 percent of the total project time, the manager 50 percent, and the staff person

20 percent. The blended rate will be \$96.50 an hour, which is computed as follows:

$$\begin{array}{rcl} \$150 \times 30\% & = & \$45.00 \\ 85 \times 50 & = & 42.50 \\ 45 \times 20 & = & 9.00 \\ \text{Blended rate} & = & \underline{\$96.50} \end{array}$$

You quote the client an hourly rate of \$100, which provides you a premium of \$3.50 per hour. If the senior consultant can manage this engagement more effectively and push an additional 5 percent of the time to the manager, the blended rate then becomes \$93.25, or a premium of \$6.75 per hour. If the blended rate engagement takes 500 hours, the firm will receive a premium of \$1,750 at the original blended rate, or \$3,375 at the \$6.75 premium scale.

**When to Use.** The work being quoted on needs to be fairly defined and you can determine with a high degree of accuracy the accountant and consultant mix necessary to provide the service.

**The Marketing and Operational Perspective.** Under this method, compared with that of having different rates for each biller, it is easy to negotiate with the client and internally administer.

It may endanger the quality of the work product, because there always exists a danger in trying to get the highest premium possible. If your firm decides to use this method, make sure that it has excellent quality controls in place.

There is another danger to this billing method. It can be highly unprofitable if the blend is at the high end. In other words, if the senior consultant in the preceding example had to spend 60 percent of his or her time on the project and the firm could only charge the same blended rate, the engagement would most likely be very unprofitable for the firm.

Depending on the time and billing system currently in use, it may be difficult to assign to several different billers a blended rate that is different from their standard billing rate.

This method encourages delegation. Partners and managers can then spend their time doing more valuable work.

## Fixed or Flat Fee Plus an Hourly Rate

As stated in Reed's *Win-Win Billing Strategies*, "In this hybrid method, the portions of the services that can be defined are charged on a fixed or flat-fee basis and those that are not capable of being defined because of uncertainties are charged on a time-rate or hourly basis."<sup>2</sup>

**When to Use.** This method can be useful when the services cannot be totally defined, or when you and the client want to share in the risk of the fee. For example, in an estate planning assignment, the initial interviewing, goal setting stage, and determination of any tax consequences can be done on an hourly basis. The preparation of the written documents can be charged on a fixed or flat-fee basis. This method provides some degree of security for the accountant, especially for those services for which it is difficult to accurately determine the total time commitment. The hourly rate portion protects the accountant from underquoting. After you obtain more information about the engagement, you are in a better position to provide a more realistic fixed fee quote. At that time, the client will also have a better feeling of where the project is going.

Accountants can also use this method in litigation services. The accountant could agree with the attorney to perform a range of routine engagements for a fixed fee, with the understanding that if the services required went beyond this range, then they would be charged for on an hourly basis. Finally, we should not forget that this method can be used with compliance work (for example, audit, review, compilation, or tax returns) that would be on a fixed fee, while miscellaneous consulting services would be on an hourly rate. You could have an arrangement with the client that any additional significant projects be quoted on a fixed fee as well.

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<sup>2</sup> Richard C. Reed, ed. *Win-Win Billing Strategies: Alternatives That Satisfy Your Clients and You*. Chicago: American Bar Association, 1992, page 94.

**The Marketing and Operational Perspective.** As we saw above, this method takes some of the risk of not knowing the final fee away from the client. Both the accountant and the client share in the risk. This normal sharing will improve communications between the two parties and the accountant will more likely do what is in the best interest of the client, rather than try to build up billable hours. Clients will realize and appreciate the efforts of the accountant and speak highly of him or her in the marketplace, thus providing more positive word-of-mouth advertising.

Use of this method makes it more difficult to prepare an annual budget since the hourly fee portion is not predictable.

### **Hourly Rate Plus a Contingency Fee**

This is a combination of hourly billing and a contingency factor. It is important to clearly define how the contingent fees will be determined. Will they be based on dollars saved or on some other outcome, such as purchasing or selling a business? This method would be used in a consulting engagement where the firm might be involved in a merger and acquisition for a company. Depending on the arrangement, some of this engagement could be done on an hourly basis plus a contingency factor (or success fee, as it is commonly referred to in the accounting profession). As you can see, this and other more sophisticated billing practices require that you communicate clearly and frequently with your clients to avoid any misunderstandings. See discussion of Rule 302, "Contingent Fees," on pages 60 and 61.

**When to Use.** This method is appropriate for situations that include a significant dollar value and a willingness to share in the risk with the client. It is certain that the hourly fee will be paid, but the contingent part is at risk.

**The Marketing and Operational Perspective.** The client will pay the full amount only if the accountant achieves all the agreed-upon results. You can be sure that the accountant will do his or her best to get results for the client.

Because of the contingency factor, a close relationship with the client should be established. This method creates more of a partnership between the client and the accountant.

This method puts an added burden on the accountant. It is necessary to assess — with a high degree of accuracy — the chances of success, since a major portion of the fees are based on results.

## **Retrospective Fee Based on Value**

This method differs in approach from most of the alternative billing methods already discussed in that the exact amount of the fee is not known to either accountant or client until the engagement is concluded. It is critical that the representation agreement set forth the factors that are to be considered in setting the final fee. In a certain manner, this approach might come closest to a satisfaction guarantee based on value, except that the service provider and the client do not yet know what the final fee will be. Nevertheless, it is the accountant who will ultimately determine what the fee will be, not the client. Again, with this kind of method, it is critical that the various factors that go into determining the fees be clearly delineated at the beginning of the engagement and that they be documented in the engagement letter.

**When to Use.** For this method, as for several others that have been discussed, a trusting relationship between the accountant and the client is critical. Each must act fairly, and there must be good communication between them. This method should be kept in mind any time an engagement may result in a better-than-expected benefit to the client.

**The Marketing and Operational Perspective.** The retrospective fee based on value method would permit an accountant to market his or her services based on the real value to the client, especially if the accountant enters a situation where there are many uncertainties and unknowns.

On the one hand, this method forces accountants to think of value rather than time spent. On the other hand, it will



make most clients wary of agreeing to this billing method since the client has no way to budget for the final expense.

## **Availability-Only Retainer**

This is a method that is seldom used, even in the legal profession. But it is one that should be mentioned nevertheless. The availability-only retainer, which is also referred to as a pure retainer, is characterized by a payment to the service provider of a specific fee for which no direct services or limited services will be performed. When you agree to accept that fee, you make a commitment to the client to be available when requested. In the legal profession, the attorney would also agree to refrain from representing either parties adverse to the client or competitors of the client within a specified time period. The billing method could be used by an accountant who has developed a certain expertise and has served as an expert witness. The accountant could develop this billing relationship with an attorney and agree to only work with that particular attorney.

**When to Use.** Retainers are useful only if the monetary amount is significant enough to justify being disqualified from taking work from other clients. I am unaware of any accounting firm that has used this method, but it would be applicable to a professional who has high-level expertise or prestige.

This billing method could also be used when doing executive search work for a client or in acquiring a business for a client.

**The Marketing and Operational Perspective.** A predictable stream of income is provided for the period of the retainer. In addition, your competitors are locked out from doing business with this client.

Work on retainer may cause some supply and demand problems since you may not know the work level required by the client or when the client will demand your services.

The accountant who is fortunate enough to bill under this scenario is apt to enjoy increased prestige in the marketplace, especially for doing expert witness work.

## **Retainer as a Deposit Against Future Services**

This method is becoming more popular with accounting firms since it helps reduce collection problems and permits the accountant to protect himself or herself against a client who, for whatever reason, may not pay his or her bills. Actually, this is not so much a billing method as a technique to ensure that the client will pay for services to be rendered. The secret to this technique is to collect the retainer on an ongoing basis so that you are always ahead of the client. This technique can also be used with a variety of billing methods discussed here. Many sole practitioners have used this method for years with their monthly write-up clients. Unfortunately, it has not spread to other services.

**When to Use.** This method should be used whenever possible, because it enhances cash flow. The technique can be used with existing clients as well as with new clients. Obviously, with existing clients, it will be necessary to communicate with them and explain your new billing procedures.

**The Marketing and Operational Perspective.** Most firms originally started to use this method to help screen out unqualified clients or clients with payment problems. From a marketing perspective, this method is more of a defensive posture than an offensive marketing tactic.

## **Unit Fee**

The unit fee is a subspecies of the fixed or flat fee in that a fixed amount is charged for a specific service, irrespective of the actual time spent. Some firms may refer to this billing arrangement as a menu billing or *ask-based billing*. The firm could have a fixed charge for every tax form, letter or page typed, telephone call, or any other form or procedure. The method could be combined with an hourly billing rate.

**When to Use.** This method has perhaps gained the most popularity in the tax preparation area. In the AICPA's 1993 book *Seasonality: Practitioners' Suggestions for Managing Work Load Compression*, there is a discussion of this method. It's referred to as a *charge per schedule*. According

to *Seasonality*, “a growing number of accounting firms are billing individual tax returns based on published fees per schedule prepared.”<sup>3</sup> This method is good to use whenever there is accurate knowledge of the time typically required to provide a specific service. In addition to tax preparation work, this method can be useful in quoting bookkeeping engagements, preliminary projections, budgets, or computer-based calculations.

**The Marketing and Operational Perspective.** This method can definitely add a premium over straight hourly billing. It requires clear communication with the client about fees. Clients usually accept this method because it is very simple to understand. Other professionals, such as physicians and dentists, often bill in this fashion.

This method will help change a firm’s culture with regard to the billable hour concept since it encourages minimum time expenditure for a specific service. Since clients are billed for the specific service or activity, the service provider will put more emphasis on performing more of these activities, rather than on trying to take as much time as possible to complete just one activity. Since activities are tracked and not timed, this method can reduce time lost from inadequate recordkeeping. It could in the long run, not only simplify timekeeping, but completely eliminate it.

## **Statutory or Other Scheduled Fee System**

The amount to be paid to the accountant is spelled out in a statutory enactment, which states whether a fee is imposed, negotiated, fixed, or flat. Or it may be specified in a prepaid accounting/tax/personal financial planning plan, similar to a prepaid legal plan. In this case, a CPA firm could offer a prepaid individual tax preparation plan or a personal financial planning/estate planning program to employees of major corporations. This would be similar to what Hyatt Legal Services offers to corporations.

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<sup>3</sup> *Seasonality: Practitioners’ Suggestions for Managing Work Load Compression*. New York: American Institute of Certified Public Accountants, 1993, page 41.

**When to Use.** Sometimes, accountants are compelled to use this method, such as when trying to include a value-added service to attest work for a major corporate client.

**The Marketing and Operational Perspective.** This type of prepaid plan will help a corporate client in cost containment, if the company is interested in providing this benefit to its employees. An employer can offer this service to its employees without any additional cost. From a marketing perspective, this kind of service can be offered to attest clients as a value-added service to their employees. Firms that are interested in growing their tax practices might want to consider this method. This pricing arrangement can also be offered to strategic alliance, for example, with financial planners who sell products but do not provide tax planning and preparation services.

## CONCLUSION

As you can see, there are many different alternatives to consider when developing your pricing strategies. The old way of thinking will go the same way as the typewriter. The billing methods discussed in this chapter strive to achieve the following three major objectives:

1. To increase the revenues of your firm as well as the bottom line
2. To improve your operating efficiencies
3. To provide superior service to your clients



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**Chapter 5**

**How to Implement  
a Change in  
Pricing Philosophy**

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**O**nce you have decided to adopt an alternative pricing philosophy, what do you do next? Changing your firm's pricing philosophy is really a three-step process. First, you need to consider several key factors before suggesting a change in your firm's pricing philosophy. Second, you need to get your partners to agree that it is a good idea, and third, you need to educate your clients so that they accept and understand the new approach. The steps are not easy, but they are not impossible.

## **PREPARATION FOR MAKING A CHANGE IN PRICING PHILOSOPHY**

Any change will, of course, be met with resistance. Before you make drastic changes to your pricing strategies, you will need to take into consideration the following key factors:

1. *What exactly will be changed?* Make sure you have a clear vision of what you want to accomplish. The best way to develop your vision is to brainstorm with your partners and get their input.
2. *Why do you want to make the change?* There will probably be two major reasons for making a change. First, it should produce more profits for the firm. Second, it should improve client service and satisfaction. It should also give you an initial marketing advantage over your competition, at least in the short run.
3. *What will be the effect of the change?* How will the change affect your clients, your firm, your position in the marketplace, your staff, and, finally, your partners or shareholders? You need to think about this and write down your answers. The more thought you give to the



entire process, the more successful you will be in the transition.

4. *What are the biggest obstacles to making the change?* Are these obstacles real or perceived? Who will resist making the change? Your clients? Your partners? Your staff? The resistance will come from all of the above. Whenever a change takes place, an organization tends to go through four stages.
  - a. There seems to be many internal, “water-cooler” conversations as everyone tries to come to grips with the announced change.
  - b. People start developing their own personal agendas. In other words, they are thinking: What’s in it for me? How can I fit into this new system?
  - c. In the third stage, they begin to accept the new organization and make a commitment to it.
  - d. In the last stage, they have fully accepted the new pricing philosophy and the new paradigm.

You will need to spend a lot of time with your people to make sure that the transition goes smoothly. Extra hand-holding is critical to the success of this venture.

5. *What programs can you put into place to overcome the obstacles to change?* Clients as well as accountants have become comfortable with the hourly billing method. You should begin educating your staff so that they understand the new pricing methods and you should be tying compensation and rewards into the new methods.

Remember that effective change needs to be evolutionary and not revolutionary. Alternative pricing strategies will evolve over time as both sides gain a better understanding of these different methods. Ultimately, it is the marketplace that will dictate the changes that we will have to make. That does not mean that you need to respond in a reactive mode. Rather, this would be a great opportunity to be proactive. To begin the process of change, it is important for you to become convinced that there are distinct advantages to using some of the alternative pricing methods we discussed in chapter 4, “Alternative Pricing Methods.”

## GETTING PARTNERS TO ACCEPT A NEW PRICING PHILOSOPHY

Before you announce your new pricing policies to your clients, it is critical that you and all the partners in your firm embrace the new pricing philosophy. The entire process begins with the following:

1. The firm's willingness to make some changes
2. An analysis of existing engagements and the economic impact that a different pricing strategy will have on the firm
3. A review of how the firm is currently delivering and producing its services
4. The firm's overall relationships and communication style with its clients

Here are some of the impediments to implementing alternative pricing methods. You will be able to add several more to this list; it seems that the reasons not to change almost always outnumber the reasons to change, a phenomenon that is quite easy to explain. Change is painful. It interrupts the daily routine, the old and comfortable work habits that the partners and staff have developed. Change is also stressful. It creates uncertainty. We really are not sure whether the change will be for the better, especially if we are one of the pioneers of the change. Once you start making changes in the firm, it becomes difficult, if not impossible, to keep making the same excuses for late billings, excessive write-offs, and missed deadlines.

The major concerns I have heard whenever I have recommended making significant changes follow.

1. *We have been doing it this way for so many years, why would we want to do it differently now?* In short, this is pure inertia on the part of the partners. My normal response to this barrier is: Can you imagine preparing tax returns today the same way you prepared them five or ten years ago? Everyone, of course, answers, "Well, no." And, some even say, "But this is different." Is it really different?

2. *I know what I'm doing now, but I won't know what might happen if I change my pricing methods.* The only way many of us will change is when the pain of not changing becomes greater than the pain of changing. But we do not necessarily have to wait until we get to that point. Change is frightening for all of us. Let's accept that as a fact. If we don't change constantly we will only be left behind, professionally and economically.
3. *I am a dominant billing partner in the firm and I have been justifying my high compensation based on billable hours; what do I do now?* Such an individual may fight tooth and nail not to make any changes. Changes would definitely weaken this individual's power base within the firm.

In addition, not only would the political power of this partner be threatened, but also his or her personal security. We all know partners who claim to have more billable time than anyone else in the firm, in fact, some even claim to have more billable time than the entire firm! If you were in that partner's shoes, how would you feel?

4. *Why do you want to change what has gotten us to where we are today?* The answer is that there are countless companies and products that failed to change with the times and are no longer in existence. Older partners will fight younger partners. It may appear to be the "young turks" against the old guard.
5. *Compensation systems will definitely need to be changed, but how?* Since most firms heavily compensate partners based on billable hours, what will be the new measurement tool? There already exists a trend in the profession to get away from using billable hours as a key measurement tool and move toward fees collected. Too many partners have been paid solely on their billable hours and not on what they actually collect. Forget billable hours and put your emphasis on the actual dollars that you bring into the firm. The following are just a few ideas on how to change your compensation system to get your partners to accept the new billing paradigm.

- Make sure that each partner has an annual billing goal, and track and report on a monthly basis the actual billing, total write-ups or write-downs, and the percentage of actual billings to fees at standard. You will also want to have a preapproved write-down policy. Any write-down over ten percent should be approved by the managing partner.
- Base partner compensation on their ability to obtain at least an 85-percent realization of overall billable time.
- Track the monthly average work-in-progress (WIP) per partner, and pay the higher billers (as long as they are not making adjustments to accounts receivable) more than the other partners.
- Many firms require that all WIP be cleaned out at the end of the year. Whatever WIP is carried forward is charged against the partner's draw.
- Make sure that partners have monthly collection goals. And to put some teeth into this, charge the partner's capital account or reduce his or her draw if their receivables exceed your guidelines. Most firms will give a partner ninety days to collect. If the receivable goes beyond that time, the partner's draw or capital account is reduced. Basically, these firms are charging their partners for the cost of borrowing money.

There will be other concerns raised among the partners in your firm. To help overcome these concerns, you might want to use the following points to bring your partners up to your readiness level. Some basic reasons to make this change — or at least to move in the direction of adopting alternative pricing methods — are as follows:

- During the past several years, American industry has learned that they can run “lean and mean” if they focus on profitability and not on production. The change from the hourly billing method will promote increased efficiency.

- Other businesses that have made the changes noted in item 1 above have also noticed increased client and customer satisfaction as a by-product of this change of attitude.
- If we increase our efficiencies, we will increase our profitability. Most services offered by an accounting firm are repetitive, even those that do not fall into the so-called compliance area. The consulting engagement that started out as a one-of-a-kind engagement soon develops into repetitive work. And once this happens, that work can be systematized.
- Firms that are not constantly innovating will fall behind those that are. Only sixteen companies that were on the list of the largest United States companies in 1900 are still on the list. *Fortune* magazine's list of the top 500 companies has seen nearly a 50-percent turnover since 1980. The Big Eight became the Big Six, which may change again. Change may be the only constant in our environment today.
- Perhaps most important, a change in pricing methods will address the clients' changing needs and their growing sophistication. More clients are shopping around than ever before. And the clients are not shopping for price, they are shopping for service and value.

To help the partners or shareholders of your firm see the advantages to making alternative pricing a reality in your firm, ask them to complete the client fee audit. Exhibit 5.1 will help you determine whether or not using a different pricing method on a specific previous engagement would have been more profitable. If you can demonstrate in dollars and cents what could happen, you are more than 50 percent of the way toward convincing them to change.

*Note:* If more than one professional serviced the client on the engagement, ask each one to write out the answer to these questions and then compare them. You will be surprised to read the different perceptions of each service provider.

***Exhibit 5.1 Client Fee Audit***

1. What value did my efforts bring to the client on this engagement? Specifically identify the value you brought to the client. \_\_\_\_\_

2. Was there a way to better manage this engagement? \_\_\_\_\_

3. How could I have done a better job for the client? \_\_\_\_\_

4. Was there someone else in the firm who could have handled this engagement more profitably? \_\_\_\_\_

5. If I had the opportunity to do this engagement again, would I use the same pricing method? If not, which method would you use? \_\_\_\_\_

6. Was I able to obtain any new engagements from this client? In other words, to what extent did I cross-sell other services? \_\_\_\_\_

7. Are there any procedures or systems that were developed for this engagement that can be used in the future? If yes, describe: \_\_\_\_\_

8. Did we employ a technology or process that could be used again? Yes\_\_ No\_\_ If yes, please describe: \_\_\_\_\_

9. Did I ask the client for a testimonial letter that highlights the value we provided? Yes \_\_ No\_\_  
If no, why not? \_\_\_\_\_

10. Fee billed to client under the existing pricing method: \$ \_\_\_\_\_

11. Fee billed to client under an alternative pricing method: \$ \_\_\_\_\_

## GETTING CLIENTS TO ACCEPT A NEW PRICING PHILOSOPHY

Once you have sold your partners on the new philosophy, you will need to sell it to your clients. There are five ways to get clients to accept the new pricing methods. Each of these methods is discussed below.

1. *Believe that clients will accept a new billing method.* If you do not believe it, you can be sure that your clients will not either. It is not unusual for physicians, stock-brokers, and attorneys to change billing methods. Actually, most of your clients will understand what you are doing if you clearly communicate with them. There is a truism that good client relationships are based on trust. The clients trust that you will do the right thing for them. If they lack this trust, no matter what pricing method you employ, you will have problems with your clients.
2. *Start new clients on the new method first.* Realize that it will be easier to start a new pricing method with new clients because you can set their expectations right from the start. Many of your existing clients have their expectations set in stone. The important thing to remember is that you are starting a process. It does not have to be completed in a day or a week.
3. *Take advantage of the moment of truth.* The current way that we communicate with clients in general and our existing billing policies, which frequently surprise clients, often hurt the client–advisor relationship. Jan Carlzon, the president of Scandinavian Airlines, coined the term *moment of truth* in his 1987 book of the same title. This term has come to be used to define that moment when a client has some form of contact with the service provider or some aspect of the company and develops an impression of the quality of the company's service. Whenever these moments of truth take place within the accounting profession, one of three things can happen to the client–accountant relationship.

- a. It can be a positive experience.
- b. It can be a negative experience.
- c. It can be a neutral experience.

Too often, the moment when a bill is sent turns out to be a negative moment of truth. You should be aware of moments of truth and learn how to use them so that they become positive encounters rather than negative ones.

- 4. *Communicate with clients.* To make these moments of truth more positive, the following are some basic steps you will need to consider in order to ensure that the new pricing process is understood and accepted by new and existing clients. All of these methods require improved and effective communication with your clients and your staff.

- a. *Put it in writing.* From the start, inform the client in writing what your pricing method will be for the particular engagement. Many firms prepare a brochure that outlines its billing philosophy and its service philosophy. The billing philosophy section can discuss billing rates, out-of-pocket expenses and other charges, direct service costs, and terms of payment and interest charges. The billing arrangement should also be clearly stated in the engagement letter.

If you decide to make a change to your pricing method, a letter should be sent to your existing clients informing them of the changes that will be made. Depending on the size of the firm, this letter can be sent from the managing partner or each individual engagement partner. You should encourage clients to let you know if they have a problem with the new pricing method. If clients are dissatisfied with something that we do, most of them just walk away rather than complain. If you give them a vehicle to voice their concerns, you will handle this moment of truth to your best benefit. The letter should also inform the clients of the benefits that



they will receive under this new method, such as improved service or lower fees for some services.

- b. *Hold face-to-face meetings.* Be prepared to have several one-on-one conversations with your clients, especially your more important clients. In face-to-face discussions with a client, you may want to suggest to the client that he or she perform additional tasks in order to reduce costs. The client may well decline to take on these added responsibilities, but at least you have given the client the opportunity to make the decision. The client will certainly appreciate this.
  - c. *Train your professional and support staff in the new philosophy.* Perhaps the worst thing that could happen would be that a client calls to get further explanation about your new pricing methods and the person who answers the phone does not know the answer. You will want to spend time educating your staff about the pricing changes. Let them come up with questions or objections that they think clients will raise. Make sure that everyone gives the same answer to these questions and objections. Also make sure that *they* are comfortable with your new approach. Remember, they also have to believe in it.
5. *Reassure your clients that your pricing policy is fair.* I cannot think of any client that I have worked with over the years that wanted to cheat me out of a fair fee. Make sure that your clients understand that you are a highly skilled professional who adds value to their business.

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## **Chapter 6**

### **How to Bill and Collect Effectively**

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**I**s the phrase *effective billing philosophy* an oxymoron? I'm beginning to believe that it is. Analysis of the results of current billing and collection procedures and policies reveals that, for the most part, they aren't working very well. It is true that most firms have some sort of a billing procedure and some even have a billing philosophy that is taught to each new associate in the firm. *But, very few firms have an effective billing and collection philosophy.*

The other factor that needs to be recognized is that one philosophy will not work for all firms. Different practices require different billing and collection philosophies. If your practice is heavily involved in governmental work, your billing and collection procedures will be completely different than if you have an estate planning practice. Nevertheless, the concepts discussed here will still apply. You will just need to adapt them to your particular practice.

Based on personal experience and discussions with managing partners and with consultants to the profession, I would like to propose what I believe are the key elements of an effective billing and collection philosophy.

1. *Know what you are providing.* Perhaps the first and most important aspect of an effective billing philosophy is for the biller — who should also be the service provider — to make the distinction between whether he or she is providing the client with a compliance-oriented commodity service, which the client may perceive to have very little value, or whether he or she is providing the client with a true value-added service that the client wants and believes is an improvement of his or her life or business.
2. *The service provider should prepare the bill.* In smaller firms this is not necessarily an issue. However, in many mid-sized and large firms, it is frequently the managers and supervisors who have daily contact with

the clients, while the partners move away from knowing what to really bill the clients. The biller should be the service provider who does the majority of the work. The partner will still approve the bill and send it, but it is proverbial that the person who does the work will usually bill out more.

3. *Bill constantly.* Bills and billing should be done on a daily or weekly basis. As soon as an engagement is completed or — even better — while the engagement is still in process, bills should be prepared and sent. The ideal would be to deliver the final bill on the day that the engagement is completed. Currently, many firms bill on the first of the month. But if the engagement is completed on the tenth, they wait until the beginning of the next month to send the bill. This approach doesn't make much sense.
4. *Keep daily time sheets.* It is becoming easier and easier to enter time sheets in real time. At a minimum, daily time sheets should be mandatory in all firms. This is a cultural change that needs to be made. It should be as if you are punching in a time clock. In order to get paid for the week's work, you need to clock your hours or your charges to the clients.
5. *Make sure there are no surprises.* All clients should know what their base fee is going to be, and they should know it at the beginning of the engagement, not at the end. The engagement letter should spell out the payment policy. Most clients will be more agreeable to your fee before the work is started and is still needed by them, rather than when the project is completed and they are finally informed of the price. Can you imagine buying something and not knowing what it would cost you and when you would have to pay for it? Think of that for a moment. It's no wonder that our clients are often surprised by and complain about the bills they receive, and pay slowly. Wouldn't you? It may seem radical, but more and more business and services are requiring payment up front. Most of us pay for professional services before we consume them.

6. *Accept only the best clients.* Make sure that the clients you accept pass *your* acceptance test. It doesn't do much good to have a whole lot of clients who just don't pay. Make sure you follow your client acceptance policy and educate your clients as to your billing philosophy. A key part of your billing philosophy should be the initial needs analysis and developing an engagement budget to complete the work.
7. *Follow fixed procedures.* This is no different than doing an audit. You have certain steps to follow and you do not deviate because you know what your exposure will be. If you deviate from your billing procedures, you will not be sued, but you will be exposed to losing thousands of dollars or more.
8. *Effectively communicate with the client from the beginning.* Just like item 5 above, constant and effective communication with your clients is critical. When you think about it, most if not all write-offs occur at the end of the engagement or several months after the final bill has been sent. Another important element in communicating fees is the manner in which you do it. It has often been said at MAP conference presentations that if an accountant lacks confidence in his or her fees, a client will pick this up and frequently request a reduction in fees. However, if the accountant is self-assured and confident that his or her fees are fair and he or she is worth every penny, the client will be more comfortable with the fee quoted.
9. *Learn how to use change orders.* Whenever there is a change in the scope of the engagement, you should issue a change order to the client outlining the additional work that will need to be performed and the added cost. Again, the change order needs to be prepared at the earliest moment so that the client can decide before the work is done whether or not he or she feels it will be worth the added fee. Most accountants do the work *first*. Then, they decide if they can bill for it or how much of the time can be billed, and then start the negotiation process with the client.

10. *The service provider should not be the one to collect.* This is the only profession that I know of where the service provider not only sells and delivers the service, but is also responsible for the collection of outstanding receivables. When was the last time you received a call from your doctor or dentist asking for a payment? Obviously, if the other steps in the billing process are done with perfection, this should not be an issue. But, in reality, there will always be some cases where you or someone from your firm will have to ask for payment. An effective procedure to follow is this: After an invoice is over 30 days late, your office manager or administrative assistant should make a soft call to the client informing him or her that the bill is outstanding and asking whether there is any problem in making the payment. The caller should obtain a fixed date from the client as to the payment. If the total amount cannot be paid, then some kind of payment schedule should be determined.
11. *Make sure your engagement letters are contracts.* Your clients should not be surprised to learn that they have entered into a binding contract with you. You should have your current engagement letters reviewed by a local attorney since the laws covering this area vary from state to state.
12. *Have your engagement letters reviewed by your professional liability carrier.* It is also a good idea to have your engagement letters reviewed by your professional liability insurance carrier. This will provide you with greater comfort in case you do need to sue a client for nonpayment. Conversely, if you are sued because the scope of your work is in dispute, the signed engagement letter outlining the work you were to perform will go far in protecting you.
13. *Use an engagement control system.* This is an effective technique to use for larger engagements. It is not recommended for small engagements. The cost of using such an engagement control system can be greater than the entire cost of the engagement. Many time and billing systems are available today that include an

engagement control module, which will take a budget for the engagement and track the time and expenses to date. This kind of system is worth its weight in gold since it will act as an early warning system for any potential problems with regard to spending too much time on an engagement.

14. *Decide at what point you will sue.* In today's litigious society, this matter comes up frequently. Most of the time, if an accountant sues, it is because the client believed that the services were not properly performed or were priced too high. Threat of a suit may indicate to the client that you are serious and are acting in a businesslike fashion. However, you need to take into consideration that the majority of suits against accountants are countersuits because the accountant has tried to collect outstanding fees. The downside is, of course, with your insurance carrier. You sue a client for \$2,000 in uncollected fees and the client turns around and sues you for \$15,000. If you develop a policy of suing clients, remember these two things: First, many times you will be countersued. Do you want to spend the extra dollars in legal expenses? Second, your premium for professional liability insurance may be increased by your carrier if you initiate several suits. If you do not notify your carrier of a counterclaim, you may lose your professional liability coverage completely! As much as 13 percent of all malpractice claims come from counterclaims against accountants.

Some firms are getting around the legal issues by taking their clients to small claims court. Do not threaten to take a client to court unless you really are going to do it. A workable policy might be: After two or three broken promises to pay, notify the client that you will be filing in small claims court within seventy-two hours unless payment is received.

15. *Bill for out-of-pocket expenses.* Many firms do not charge back to their clients the expenses incurred in the servicing of their account. The term *out-of-pocket expenses* has come to cover a large array of items. It is not unusual for firms to bill clients for the following:
  - Local and long distance telephone charges



- Faxes (both incoming and outgoing)
- Secretarial support time
- Computer time (both in the field and in the office)
- Messenger services
- Photocopying
- Per page charges for typed documents
- Engagement setup charges

Some firms even add a fixed amount per billable hour for scheduling and setting up the client files. The total amount of these charges can be significant. Even if a firm decides not to bill them separately, it is important to capture them in order to determine your true cost of servicing the client. Most of these charges can now be easily captured through software that interfaces with the firm’s time and billing system. The charges can be downloaded daily to the client’s billing code.

Cost recovery applications have been commonplace in large law firms for some time. They are not as common in small and mid-sized accounting firms, perhaps because the technology costs too much. Today, however, technology costs should not be a factor in capturing these expenses. According to a 1993 article in the *Illinois Legal Times*, most professional firms are charging clients for only 50 percent of their photocopying volume. The article gives the following example for a typical law firm:<sup>1</sup>

**Table 6.1**

Average monthly copier volume	25,000 copies
Average number of copiers in firm	1 per 15 staff
Percent of billable copies	70% to 80%
Client charge per copy	\$.20
Cost to firm per copy	\$.07

<sup>1</sup> Paul Bernstein, “How Your Firm Can Recover Some Operating Costs,” *Illinois Legal Times*, vol. 7, no. 77, p. 7.

Assume that the cost of the cost recovery devices and software for two copiers is a total of \$8,500. If the firm could increase its cost recovery from just 50 percent to 75 percent of total photocopying expenses, the following is how the figures would work out:

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**Table 6.2**

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Monthly copy volume assumed	50,000 copies
Revenue with a computer system	\$5,000 a month
Increase in revenue from	
50 percent to 75 percent	\$2,500 a month
Annual increase	\$30,000 a year
Cost of the two cost recovery systems	\$8,500

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If you don't think that there is money to be made in capturing out-of-pocket expenses, just think of this example.

16. *Capture finance charges.* Similar to other charges, if you do not capture finance charges, you will never be able to bill them. Too many firms are in the business of lending money to their clients, especially their long-term clients. New clients as well as older ones should be made aware that interest will be charged if bills are not paid within thirty days. Many firms will charge 1 percent on outstanding balances over thirty or sixty days. The going rate charged by most firms seems to be 1 to 1.5 percent.
17. *Take credit cards.* There is an easier way to extend credit to your clients without the firm having to act as a lending institution. During the past several years, the use of credit cards to pay for tax preparation work has become common. You will not find many clients paying for their accounting work with a credit card. There are several benefits to accepting credit cards. The main one is that you no longer have to worry about a receivable. Depending on the credit card and the volume you charge, there is a charge to you for the use of the card. It appears that most firms accept either American Express or VISA cards.

18. *Put your philosophy in writing for your staff.* Whatever your firm's billing and collection philosophy is, it is important to put it in writing so that partners and staff have a clear understanding of it and follow it. Your billing and collection philosophy forms the basis of your billing and collection process. It has been said that if you put ten partners in a room together, you would get ten different billing philosophies. It is important to get the partners or shareholders in the firm to agree upon basic principles.

## Epilogue

One of Henry Ford's famous quotes seems most appropriate to end this discussion on fee setting.

Whether a man thinks he can or thinks he can't, he's probably right.

If you think that there is only one way to price your services, then you are probably right. However, if, after reading this book, you think that there are many different ways, then you are probably also right.

Reread this book. By doing so you will remind yourself how you can show your clients the value that you bring to each and every engagement. You will also reinforce your thinking (If you think you can, you can. . . ). Set a goal to incorporate one idea that you found appealing in this book. Practice what you have read here. The old saying, "Practice makes perfect," certainly applies here. If you take one new idea and implement it, then I have succeeded in my goal in writing this work.

I strongly believe that accounting firms need to adopt innovative pricing and service delivery strategies to remain profitable. If they do not, the cost of doing business will soon overtake their revenues. This, then, is the challenge for the successful accounting firm of the future. Do not be afraid to go forward into the unknown. The earth, as we found out many centuries ago, is not flat. Have no fear that you will fall off. Rather, imagine the new world that you will discover.



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**Appendix**

**Publications and  
Programs of the  
Management of  
an Accounting  
Practice Committee**

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## PUBLICATIONS

To order AICPA MAP Committee publications, call the AICPA Order Department at (800) 862-4272 or (201) 938-3000 (outside U.S.).

**MAP Handbook**, a comprehensive 1,000-page, three-volume loose-leaf reference service on practice management, is updated annually. It includes more than 200 forms, sample letters, checklists, and worksheets, all easy to reproduce or adapt for your practice needs. It provides detailed financial data and policy information, for firms of various sizes, that enable you to compare your performance with that of comparable firms. Topics covered include developing an accounting practice, administration, personnel, partnerships, and management data.

**MAP Selected Readings**, a companion book to the *MAP Handbook*, is a readers' digest of over 500 pages of articles on successful practice management, specially compiled from leading professional journals. The articles contain numerous profit-making ideas for your practice. A new edition is published annually.

**On Your Own! How to Start Your Own CPA Firm** provides nuts-and-bolts advice on how to start a CPA firm. It contains a wealth of hands-on information on operating profitability, and is useful to both new and established firms as well as to prospective firm owners. Product No. 012641.

**Organizational Documents: A Guide for Partnerships and Professional Corporations** is a guide to drafting a partnership agreement and corporate documents. The book includes a sample partnership agreement with more than 100 provisions and a step-by-step approach to incorporating. Book: (No. 012640); WordPerfect 4.2 disk: (No. 090091); Book and WordPerfect 4.2 disk set: (No. 090096).

**Management Series** booklets cover the issues you and your clients are dealing with now. Designed to help solve management problems, the series includes *Management of Working Capital* (No. 090060), *Financing Your Business* (No. 090061), *Making the*



*Most of Marketing* (No. 090063), *Managing Business Risk* (No. 090062), *International Business* (No. 090064), and *Human Resources* (No. 090065).

**Practice Continuation Agreements: A Practice Survival Kit** explains how you can preserve the value of your practice in the event of death or disability. A practice continuation agreement can prevent the value of your practice from dissipating, provide financial and emotional benefits to your family, and help fulfill your professional responsibility to your clients. Product No. 090210.

**Managing the Malpractice Maze** offers firms specific techniques for lowering their risk of liability. It identifies criteria for evaluating a firm's existing defensive practice program and shows how to develop such a system if one is not in place. The book also features a ten-step plan to follow when a claim is brought and discusses such vital management issues as practicing without insurance, documenting engagements, selecting an attorney, and implementing a quality control system. Product No. 090380.

**Winning Proposals: A Step-by-Step Guide to the Proposal Process** takes you through every step of the proposal process from its preliminary steps to conducting a postmortem following the prospective client's decision. Detailed chapters explain how and where to conduct research, what to look for during on-site visits, how to map out a strategy that distinguishes your firm from competitors, how to identify the appropriate composition of the proposed document, and how to ensure your sales presentations work. Product No. 090390.

**Managing by the Numbers: Monitoring Your Firm's Profitability** assists you in your efforts to improve your firm's long-term financial performance. It helps you identify immediate opportunities within your firm and provides you with a dynamic tool to manage your practice better on a regular basis. The book instructs you step-by-step how to examine the numbers behind the numbers and uncover situations that may not be obvious in conventional financial statements. Product No. 090220.

**Seasonality: Practitioner's Suggestions for Managing Work Load Compression** is a summary of creative approaches that address this profession-wide problem. The suggestions come from the responses of over 100 managing partners to a MAP Committee survey on seasonality, as well as tips gleaned from AICPA MAP conferences and professional publications. *Seasonality* is an impressive compilation of initiatives used by firms to

increase profits and improve quality of life for owners and staff. Product No. 090400.

**Strategic Planning: A Step-by-Step Guide to Building a Successful Practice** provides a detailed approach to the design and implementation of a strategic plan. The process can be applied by both small and large firms. It will produce not only action plans and a documented strategic plan, but also create the synergy, focus, and commitment that enables firms to maximize opportunities for growth and profits. Product No. 090402.

**WordPerfect in One Hour for Accountants** is a crash course in the most popular word processing and document storage software package used by accountants. It is designed for the busy practitioner who wants to get up to speed in WordPerfect basics without slogging through a complicated user manual. In four easy lessons, you will learn the basic steps for getting a simple job done using WordPerfect. The four lessons average about 15 minutes each. That's your WordPerfect in one hour! Product No. 090085.

**WordPerfect Shortcuts for Accountants: Merge and Macros in One Hour** is the next step in mastering WordPerfect functions. In four easy lessons designed to take no more than 15 minutes each, you'll soon learn how to automate a multitude of functions by taking advantage of WordPerfect's macro and merge features. Product No. 090086.

**The Marketing Advantage** is your one-stop reference on how to market a CPA firm. This book contains comprehensive, practical advice *for* CPAs and marketing professionals *from* CPAs and marketing professionals. Over two dozen managing partners, marketing directors, and consultants contributed to the book. Product No. 090404.

**Advisory Comments for Growth and Profitability: A Guide for Accountants and Consultants** shows you how to identify client problems; develop client-specific recommendations; determine and overcome political obstacles that may cause a client to reject helpful recommendations; prepare an effective management advisory letter that includes clear, concise, and readable advisory comments; and follow-up on cross-selling opportunities. Product No. 090408.

The **MAP Roundtable Discussion Manual** contains guidelines for organizing a MAP roundtable discussion group. Such a group can help firms find practical solutions to common problems

through regular meetings and information exchange. The guidelines include sample correspondence, forms for administering a roundtable, and nearly forty suggested discussion outlines on topical management issues. To order, call (212) 596-6138.

## PROGRAMS

**MAP Large Firm Network Group** meets twice a year for in-depth MAP discussions and to exchange information on firm operations and professional issues.

**Executive Education Program**, developed with the University of Texas at Austin, offers partners and managers of CPA firms affordable instruction on executive-level management theories and techniques. The program consists of six two-and-a-half-day modules, with two modules presented each year.

For further information on these programs, call (212) 596-6138.

**The Practitioners' Symposium** offers high-quality continuing professional education to practitioners on topics such as small firm management, larger local/regional firm management, technology, accounting and auditing, tax, advisory services, specialized knowledge and personal/professional development. Call (800) CPA-FIRM for more information.

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August J. Aquila is one of the country's leading consultants and authorities in the areas of profit improvement, new business development, strategic marketing planning, and management issues for CPA firms. Since 1979, he has specialized in helping professional services firms develop and manage new business. In 1986, he had the distinction of becoming the first marketing director to achieve an equity position in a CPA firm (Friedman, Eisenstein, Raemer & Schwartz—FERS) in the United States. For eleven years, he was affiliated with the Practice Development Institute (PDI) and helped to make PDI one of the country's premier marketing and consulting firms to CPAs.

He is the coauthor of *CPA Firm Mergers That Work* (Irwin Professional Publishing, 1994) and a contributing author to *The Marketing Advantage: How to Get and Keep the Clients You Want* (AICPA's Management of an Accounting Practice Committee, 1994). He received the 1992 Annual Literary award for the best article of the year from the *Journal of Accountancy* ("How to Lose Clients Without Really Trying," May 1992). In addition, he has written over one hundred articles. His articles have appeared in *Accounting Today*, *CPA Marketing Report*, *The Management Advisor*, *The Marcus Letter*, *The CPA Software News*, and *Quality Client Service*. He has been quoted extensively in various trade publications.

He is a founding board member of the Association of Accounting Firm Marketing (AMM), and currently serves on the Executive Committee of *Accounting Today* and *The Marcus Letter*. He is a contributing editor to *The CPA Software News* and *CPA Profitability Monthly*. Dr. Aquila has been a frequent speaker at AICPA and state society conferences and has addressed the Chartered Accountants of Alberta at their annual meeting. He has consulted with hundreds of firms, both here and in Canada.

A Fulbright Fellow, Dr. Aquila earned a B.A. and an M.B.A. from DePaul University (Chicago) and a Ph.D. from Indiana University (Bloomington). For fourteen years, he taught service marketing courses at DePaul University's Graduate School of Business.



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